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PROFESSOR PAUL A. SAMUELSON

Hearings held at

OTTAWA

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Date. October 19, 1962

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F.J. Nethercut and R.J. Young
Toronto, Ont.

ROYAL COMMISSION ON BANKING

AND FINANCE

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Hearings held at Ottawa,
Ontario, on Friday,
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THE COMMISSION

The Honourable Dana Harris Porter
Chief Justice of Ontario
Toronto, Ontario - Chairman

Mr. W. Thomas Brown, M.B.E.
Investment Dealer
Vancouver, British Columbia

Mr. James Douglas Gibson, O.B.E.
Banker
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Mr. Gordon L. Harrold
Agriculturalist
Calgary, Alberta

Mr. Paul H. Leman
Corporation Executive
Montreal, Quebec

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Dr. W. A. Mackintosh
Vice-Chancellor
Queen's University
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Mr. H. A. Hampson - Secretary

Mr. Gilles Mercure - Joint Secretary

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--- At 8.45 A.M. the hearing resumed.

SUBMISSION OF

PROFESSOR PAUL A. SAMUELSON

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THE CHAIRMAN: This morning we have a submission from Professor Paul Samuelson, Professor of Economics, from the Massachussetts Institute of Technology and formerly adviser to the United States government. He is also an author of numerous works.

It is a great pleasure to have you present with us this morning, Dr. Samuelson. We look forward very much to the discussion which will ensue, and in spite of the late arrival of the brief we have had an opportunity of reading it and had some discussion on it last evening, and we look forward to the discussion here this morning with great interest.

It is not necessary, as a rule, for a witness to make any preliminary statement unless he wishes to do so; having read the brief, it is unnecessary to summarize it for us. The various points will develop as we go on and the viewpoints that you think should be mentioned are entirely, of course, in your hands. If it suits you, we will now proceed.

Are there any questions?

COMMISSIONER LEMAN: Dr. Samuelson, I have read your memo, although I can't claim to say I really have had a chance to digest it properly so you will

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Are there any questions?

COMMISSIONER LEMAN: Dr. Samuelson, I have read your memo, although I can't claim to say I really have had a chance to digest it properly so you will

forgive me if I ask questions that you may feel were answered in your memo. I may have missed some as I went through it.

Also, if you don't mind, I would like to change the order of this a little bit because I have a bent for talking about objectives before discussing the means of achieving them, so I would like to start on this question of the objectives and the conflict of objectives.

You seem to make a case here for making sure that in this discussion on conflicts of objectives that no one gets hypnotized by any one of them and makes too much of a sacrifice to achieve them, et cetera; however, in setting up a central bank there has to be some kind of a legislative authority for its constitution and the way it should operate. Do you have a fairly clear view yourself of what should be the official statutory objectives set before a body which is called a central bank?

PROFESSOR SAMUELSON: May I first say in a perfunctory way that I am speaking throughout all this simply as a professor of economics without any official capacity.

Secondly, the Chairman was kind enough to call my submission a brief. It is very lengthy and came very late, and I apologize for that. If I had had time I would have written a shorter paper.

With respect to objectives, most central banks in the world were fortunate that they were born in a fit of absent-mindedness and didn't

require constitutional instructions in the beginning. The Bank of England didn't start out as a central bank, but if one were to set out explicitly to put down the ground rules for a central bank, my feeling is that the instructions should be general rather than specific.

This comes out of the actual economic analysis in my submission, having to do with automatic rules. How nice it would be if the mechanism of economics were such that a lawyer drawing up the papers for a central bank could be given explicit instructions which he could put into the constitution of the central bank, so that the public would be entitled to know at future dates whether the officials of the organization had properly been carrying out their mandate. To my mind this, however desirable, isn't possible in any detail because of the economics of the situation, and I would refer to the similar problem of the Employment Act of 1946 in the United States.

This was a pivotal piece of legislation, which went through our Congress after very much discussion. The official wording is of an extremely abstract and general sort: that it is the intention of the government to secure the maximum of purchasing power, employment, and quite a number of the other good things of life. (They seem to have forgotten price stability at that time and it has been suggested that it be amended). Now in response to your question it must be evident that men of good will could do quite different things and each still say that he was within the

framework of the mandate of that legislation. So I would say that if I as a drafter had to put in a list of things which it was the duty of the central bank to watch, I would make sure that it was a long list or a very general list, and not highly specific.

For example, it would have been a tragedy if in the Federal Reserve Act of 1913 there had been highly specific instructions embodying the best judgment of the legislators and economists and bankers at that time, because the behavior of the Federal Reserve System has been almost opposite to that intended by the founders of the 1913 Act. The founders of that Act thought it was a most important thing to have an elastic currency, one which would automatically expand every time farmers, merchants and industrialists needed money.

In fact, Governor Strong, one of our great central bankers, the Governor of the New York Federal Reserve Bank, and the man who dominated the 1920's discovered in actual operation the whole device of open market operations; and there would have been nothing, I daresay, in the 1913 charter, if it had tried to be specific, which would have empowered the Federal Reserve to use open market operations, which I think would have been detrimental.

Now, we all have a way of getting out of our own way and Acts do come to be modified, but I don't like strict constitutional jackets in economic affairs if they can be avoided. That is a personal opinion.

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COMMISSIONER LEMAN: But it seems to me that in your memo when you move from what you call the economics and objectives and begin to narrow down a little bit on this to some specific responsibilities in the monetary policy field, you seem to come back pretty well to a mix of the objectives which are the maximum utilization of all resources, growth and price stability and a good balance between these three. These are still the most recognizable objectives, are they not?

PROFESSOR SAMUELSON: Yes.

COMMISSIONER LEMAN: Now, you make a distinction there in Section 16 of your brief where you talk about stocks of money and near money being mostly the result of monetary action and flows of income being more pertinent to, say, fiscal policy. I was very much interested in that distinction. Do you believe that the areas that are concerned with stocks, that all the areas concerned with stocks of money and near money are clearly identifiable and in this case that one can think of reorganizing the various institutional authorities to say, "Well, we will have one that will deal with stocks everywhere where they are concerned, and we will have another that will be interested in the flow"?

PROFESSOR SAMUELSON: First I would say, as in all empirical phenomena, one thing shifts into another and there are certain problems of identifying boundaries. There are certain operations which are clearly of the stock asset and not of the flow type;

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PROFESSOR SAMUELSON: First I would say, as in all empirical phenomena, one thing shifts into another and there are certain problems of identifying boundaries. There are certain operations which are [illegible] of the stock asset and not of the flow type;

this is the accounting distinction between a balance sheet and a profit and loss or income flow statement. There are other operations and transactions which seem to be on the borderline.

In making the distinction between stock analysis, I want to warn at least the American readers that it is not equity stocks which are being discussed here. In making this distinction I am merely trying to determine what, after all, is monetary and credit policy as against fiscal policy. However, I don't necessarily deduce from this that the central bank is to be the exclusive agency which handles stocks and that the treasury, is to be the exclusive agent which handles flows.

Now, I refer to Dr. Holtrop's submission to you, which I have had the opportunity of reading. He puts it very correctly, I think, that debt management is without doubt part of stock rather than flow, and yet in his country -- and I may say in my country too -- the responsibility for debt management is not with the central bank. I myself would like to see a much closer co-ordination between conventional central bank monetary policy and debt management; and I can imagine certain arguments being made for having the central bank do the debt management; or having the central bank within the government itself, doing its central banking policies and debt management there. But I don't think that I would regard my analytical distinction as a good reason for throwing all stock operations altogether in a new constitutional

specification.

COMMISSIONER LEMAN: You do still seem to favour some separation of responsibilities between treasury and the monetary authority, do you not, although they have common objectives? You do feel there should be a reasonably clear separation of responsibility?

PROFESSOR SAMUELSON: I incline in that direction for historical reasons; the institution of central banking grew up in this way. I think that you pay a price if you move too fast away from the actual pattern of development. But, as I mentioned, in looking ahead 25 years I believe that the independence of the central bank is much less today than it was earlier and will be much less in the future. Yet I think there may be certain minor advantages in still keeping the central bank as a distinct entity.

COMMISSIONER LEMAN: Well, perhaps that is a too simple approach to the problem of organization, but it seems to me that if one leaves things a little too blurred as to responsibility, you end up with about fifteen cooks trying to stir the same sauce, and I think that we get afraid of that situation and that is why I was asking if you think this notion of stocks against flows in general would be a better line of demarcation.

PROFESSOR SAMUELSON: Yes, I would say that if you could look upon this purely as an engineering problem and not have the traditions and human emotions

and certain democratic pressures of the moment, in principle I would like to see these things unified.

Lord Cobbold made a very picturesque reference in his statement to you. He imagined an automobile, and he said that it is not a good thing to have one person with his foot on the brake pedal and another person with his foot on the accelerator pedal. I think the image could be sharpened even more in the field of debt management. It is a problem of two people fighting for the steering wheel. The car is being driven with the Federal Reserve having its hand on the steering wheel and the treasury with its hand on the steering wheel. When those two people are sweethearts and close friends this may work out very well. But when there is friction, and there has been friction -- I am not now referring to any specific incident in my own country, but any student of the problem could give you half a dozen cases of extreme friction, -- this is very bad. It is a case of pull Able and pull Baker.

I will give you an example of this. Australia had a crisis in the 1930's between the central bank and its government and the former was economically wrong. (I want to make it clear that in most of these cases it is wrong to concentrate on the Treasury with a capital "T". It is a problem in my country of the executive branch of government as against the central bank. The problem in a cabinet system of government will show itself in different form, but in every case there can arise a conflict

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between the government and the central bank.)

May I give another illustration. This is one of not quite such ancient history.

In the Truman administration there came a time of discord between the Federal Reserve Board and the President; and the Treasury as I recall insisted upon floating some short-term bills at rates lower than the Federal Reserve Board thought were proper. The Federal Reserve Board -- I don't remember the details and if I have some of them wrong my point may still be valid -- the Federal Reserve Board said "All right, you may issue them". What they then did was to take them completely off the market; and since the Fed. is in the 100 per cent excess profits bracket it was just as though the Treasury had not accomplished its purpose at all. I do not think that is a good way to run a railroad, though it is a way of dramatizing and bringing to the public the conflicts of opinion which people in high authority have.

COMMISSIONER LEMAN: Well, Professor Samuelson, in your Section 13, beginning on page 28 you suggest that if there was a similar commission to this one sitting 25 years from now, the list of topics that they would be emphasizing in their discussions would be quite different from what it is today. Is that just an expression of confidence on your part that this question of independence of the central bank will be clearer in everybody's mind in 25 years, or does it go further than that? Is it your confidence that this business of conflict

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of objectives and harm that can result from, let us say, a certain amount of inflation; price inflation et cetera, will also become a lot clearer in everybody's mind in 25 years?

PROFESSOR SAMUELSON: I think it is primarily a reflection of the historical fact, which is perhaps not an accident, that the central banks of the world have felt themselves to be a minority group, more preoccupied with the problem of price stability than the elected parliaments of the world; and that in a sense they have had their heels dug in against inflation. I should not say it is a last ditch fight because it will go on for a long, long time, but in the privacy of their boudoirs when they look into their own hearts they say to themselves: "In the good old days there was greater integrity all around and there was greater independence of the central bank, and there just is not that now, though we are still fighting what we regard as the good fight".

I think there is a definite trend toward curbing the independence of central banks. Read the Radcliffe Report, the Japanese Inquiry, and the American Commission on Money and Credit. Any one of those would be shocking to the central bankers of the past, such as Governor Strong. In that sense I read the trend of the times; and it happens not to be the one that I would disapprove of as they would.

COMMISSIONER LEMAN: Well, I was trying to read into it, perhaps, the prediction on your part

of objectives and then what the results from, let us say, a certain amount of inflation; price rigidities et cetera, will also become a lot clearer in everybody's mind in 20 years?

PROFESSOR SAMUELSON: I think it is [illegible] is perhaps not an accident, that the central banks of the world have felt themselves to be a minority group, more preoccupied with the problem of price stability than the elected parliaments of the world, and that in a sense they have had their backs up against inflation. I should not say it is a last ditch fight, because it will go on for a long, long time, but in the privacy of their boudoirs when they look into their own hearts they say to themselves, "In the good old days there was greater integrity all around and there was greater independence of the central bank, and there just is not that now, though we are still fighting what we regard as the good fight".

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COMMISSIONER [illegible]: [illegible] I was trying to read into it, perhaps, the [illegible]

that inflation will not be, during the next 25 years, an acute problem that our economies will be watching for?

PROFESSOR SAMUELSON: I had intended no such notion.

COMMISSIONER LEMAN: Well, if I might home in a little bit on this question of price stability, it seems to me you feel that this whole question can be exaggerated in peoples minds. In other words, that one should not be too dogmatic and say we must have absolute stability; one should not even say we should have a gradual deflation, and perhaps if it looks as though there is building in a very slow price inflation, well then leave that because you can compensate that with various -- I would not call them gimmicks, but various off-setting factors that the government can watch over. Then you seem to say that there are two types of price inflations that should be feared. You refer to the cost-push one and then the type of run-away inflation which may stem from what you call either wars or social disorganization. As far as the first one is concerned, the cost-push type, what is your fundamental reason for saying that is the one to fear? Is it because it can become the run-away, or because it is a particularly bad kind of inflation?

PROFESSOR SAMUELSON: I had hoped to write a section of some considerable length on the problem of a "seller's" or "cost-push" inflation as against a "demand-pull" inflation. Unfortunately the clock

ran out on me and that did not get written, so I welcome the opportunity of saying some words about it.

For countries like the United States, Canada, and the U.K. I am not concerned about the galloping inflations of the type we have had dramatically in the past. The proto-type for my generation was the post World War I German inflation from 1920 to 1923, in which the income from a life, expressed in German marks, would in the end not buy a package of cigarettes or even one cigarette. Throughout history inflations like that have occurred and they are still occurring, for instance, after World War II in China and Hungary and a number of places.

I am not concerned about astronomical inflation, not because I do not understand that it is a horrible thing -- it is a horrible thing -- but because it is not a threat to our democratic society. In particular I do not think it inevitable that a very gentle price rise will go from a creep to a lope, then from a lope to a trot, until you are finally in such galloping inflation. Very few of the dramatic ones started in that way. I do not think there is any reason to worry about that. I worry about a cost-push inflation because there is some evidence that, in the institutions of a modern democratic mixed enterprise economy, there is a tendency for costs and prices to rise long <u>before</u> unemployment is at a minimal level, and long before excess capacity has disappeared. It is remarkably sad how few countries of our type have had in the post-war world

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simultaneously high employment and price stability.

In the case of my own country in the post-war there was a brief period, just prior to 1953, when we had both of those happy conditions; but they are very rare. So I worry about cost-push, not because it is the most dreadful danger one can imagine, but because it is the most relevant one.

The second reason I worry about it is that it is the hardest thing to handle by fiscal and monetary policy. I want to emphasize that it is as much a problem for fiscal policy as it is for central bank policy. I devoted a number of pages of my submission to the question as to whether the central bank had some peculiar way of affecting the price level factor in the P times Q relationship, and I concluded it had no such power. It is as much a problem for fiscal policy as for the central bank.

Now, if you have the old-fashioned demand-pull inflation, there arises primarily a problem of dosage. My old teacher of economics in Chicago, Professor Paul H. Douglas, who went on to become a Senator has dramatized demand-pull inflation in Congressional hearings and over the T.V. in the following way. Here is this glass partly filled with water. There at the top is the full employment or high employment point. If you look at that glass you see that there is not enough money spending to achieve the full potential amount of goods. Therefore the Treasury or the central bank looks at its many weapons for extending purchasing power, in order to fill the

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glass fully. And it is a matter of dosage. It adds water in this way -- just about up to the lip.

Everybody recognizes that when you try to define the exact point of full employment you are in trouble, and there is a problem as you get very near it. Most believe it is just a little bit below the rim of the glass. What would happen if it were all just a question of demand-pull inflation? I am not going to be as dramatic as Senator Douglas, but he adds even more water than I am doing, and then you see the water overflowing on to the table, depicting demand-pull inflation in action. He would then insist that all the central bank and fiscal authorities have to do is reduce the amount of aggregate spending. They can reduce this in a variety of ways, not all equivalent, but each designed to accomplish the purpose. You can run a larger surplus by an increased tax rate; or you can reduce the amount of money by open market sales of securities. Or you can raise the discount rate and change the legally required reserve ratios of the banks. You then bring the water down to this correct level. So it is a very badly mismanaged economy that has extensive trouble if only demand-pull mechanisms are involved.

In the case of a cost-push inflation, even when the employment index is way down, and there still seems to be excess capacity, you find a tendency for the water to overflow and for prices to rise. I think this is best dramatized for the economists by what has come to be called the Phillips Curve.

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Professor A. M. Phillips of the London School of Economics wrote an article in Economica some few years ago which gave rise to very considerable notice, criticism and discussion. It was a historical study of the relationship between the degree of unemployment in Britain's economy and the rate of price rise or wage rise.

A very nice Phillips Curve that permits only the demand-pull inflation would be one with the comfortable property that until you get down to low unemployment rates there is no steady pressure from the supply and cost side for prices to rise. Then the old demand-pull analysis would be very adequate. Unfortunately, a very nice kind of Phillips curve is not the kind experienced in the United Kingdom and Sweden, and a number of other modern economic systems. Instead the realistic Phillips curve has a way of showing price increases at times of considerable unemployment -- higher I would say for the United States than for many countries, but perhaps there is some similarity between Canada and the United States. I would not want to comment on that since I have not studied that question in Canada.

This creates a tremendous dilemma for the fiscal and monetary authorities because it is no longer a matter of dosage. In an extreme case, if you refuse to give in to the price rise, you create unemployment. Now, it would be a happy situation if you created a little and temporary unemployment, and then found that it chastens the attitude of the

Professor A. W. Phillips of the London School of Economics wrote an article in *Economica* some few years ago which gave rise to very considerable notice, criticism and discussion. It was a historical study of the relationship between the degree of unemployment in Britain's economy and the rate of price rise or [illegible]

A very nice Phillips Curve that permits only the demand-pull inflation would be one with the comfortable property that until you get down to low unemployment rates there is no steady pressure from the supply and cost side for prices to rise. Then the old demand-pull analysis would be very adequate. Unfortunately, a very nice kind of Phillips curve is not the kind experienced in the United Kingdom and Sweden, and a number of other modern economic systems. Instead the realistic Phillips curve has a way of showing price increases at times of considerable unemployment -- higher I would say for the United States than for many countries, but perhaps there is some similarity between Canada and the United States. I would not want to comment on that since I have not studied that question in Canada.

This creates a tremendous dilemma for the fiscal and monetary authorities because it is no longer a matter of dosage. In an extreme case, if you refuse to give in to the price rise, you create unemployment. Now, it would be a happy situation if you created a little and temporary unemployment, and then found that it chastens the attitude of the

sellers in the economy; we could then go right back to a nice Phillips curve again. Although this action creates unemployment, it might be regarded as an investment in success. And it would involve only a little slack in the system.I think this is called Parishism in the United Kingdom after Professor Parish of the London school: that is, a policy of deliberately creating a little slack so as to get rid of this bad cost push. But it is not clear that this would work out nicely in the experience of the United States.

Chairman Martin of the Board of Governors of the Federal Reserve once asked in Congress the question: "Suppose there is an element of cost-push, does that mean the central bank should be less restrictive or more restrictive?" He did not pause for an answer, but I thought that his own opinion was perhaps indicated in the context -- namely, that the attempt to stabilize prices is all the more important in a cost-push situation. I must confess my doubts. In my opinion, it is a real dilemma. In certain circumstances you will find yourself, I think, as the good pragmatic decision-maker, giving in a little along the price line, compromising with evil, tolerating some slight amount of increase.

I want to emphasize that it is never the business of the Governor of the central bank to say publicly: "I am a realist. I know that one must compromise with evil and must tolerate a price increase." In season and out of season he must

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preach against it in his public statements. I do not mean that there is a double standard of morality. What I mean is that public statements are construed in a different way from private opinions and beliefs.

Yet I think it would be a tragedy in many modern economies if a dogmatic central banker, brought up in an earlier tradition, in a position of insulated power, on the basis of his pragmatic feeling as to how this conflict of goal should be decided, were for a considerable number of years to be permitted to pursue <u>his</u> policy.

That would be a tragedy for a variety of reasons, including the fact that money policy would be by-passed. Here Lord Cobbold's image of the brake pedal comes in. We find the spectacle of the central banks of the world using high interest rate policy in order to check loose fiscal policies of governments. You may say that you have accomplished the same purpose in terms of controlling effective demand, and perhaps you have; but what you have done is loaded the dice against growth. You have loaded the dice in favor of current consumption spending, and put most of the pressure on investment and net capital formation spending. That is all very well if people are in a Galbraithian mood and do not want growth, but I do not see any evidence of that in the hypothetical situation I am mentioning. I see only evidence that the central banker is inflexible and a vestige from an earlier time, when perhaps the Phillips curve of the world behaved in the nicer way that you might

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dream of.

COMMISSIONER LEMAN: Professor Samuelson, would you just clarify one point which came up as you were talking. Do you really feel, therefore, that a situation where there is possible inflation clearly recognizable -- and let us say clearly recognizable -- because there is not what one would consider an acceptable growth rate in the economy, and there is no reasonable employment of resources, you are then facing a true break-down of what we know as a market economy operation?

PROFESSOR SAMUELSON: I think "break-down" is too strong a word. But I do think that you are facing a dilemma in which a perfectionist will become somewhat disillusioned with controls of aggregate demand and free markets. I think Mr. Sproul in his excellent submission before you, which I have had the opportunity to read, hinted at that when he said that one must not rely too much on monetary policy; and I think I would add in this context that one must not rely too much on fiscal policy. One must look for new mechanisms which will ameliorate sellers' inflation problems. I should like to add that I have no constructive suggestions in this area. This is an area of the most perplexing kind.

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which took place recently in the United States. I have no opinion whether that was, on balance, a good thing to have done before the fact. I do not have an opinion whether on balance that was a good thing to have done after the fact. Certainly any great enthusiast who thought such kinds of intervention would solve the Sproul dilemma, received no great amount of comfort from the incident. But the ingenuity of free democratic societies may develop new mechanisms.

In that sense, rather than use the word "break-down" I would speak of a "dilemma". The Commission on Money and Credits in the United States, in the course of their deliberations, became more aware of this problem. In their final report they showed considerable unease about this. As a zealot would say, they sacrificed the important goal of absolute price stability. A pragmatist might say that they recognized some of the facts of life and showed the need not to be dogmatic about any one objective in a situation where there is conflict and there is a trade-off between objectives.

COMMISSIONER LEMAN: This discrepancy which exists in the situation where you have wholesale prices reasonably stable and yet consumer prices keep on creeping up, say by one per cent, despite the stability of the wholesale prices, is a form of cost-push inflation, is it not?

PROFESSOR SAMUELSON: I think not necessarily. I made some comments in my paper on the interpretation of the official indexes. We had a

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committee set up at the request of the U.S. government to look into this. Professor George J. Stigler, of the University of Chicago, was chairman; and his committee came to the conclusion that, as many economists had already suspected, it is quite impossible to make due allowance for quality changes, so that a one per cent increase in the reported consumer price index, given a margin of error involved in all these things plus this conceptual error of definition, could be quite compatible with a true price index showing no increase at all. In that sense, for the moderate figures you have given I would say that there is no particular indication of a cost-push.

Now, I want to add that in the realm of services we have shown less productivity improvement even after you have corrected matters for quality changes. Yet many of the service markets, from the labour viewpoint, are more competitive than are the goods markets. So, that kind of <u>cost-push</u> which we relate to unilateral union pressure, organized labour, union official pressure, and to administered prices by corporations alleged to be possessed of some degree of market power, <u>is peculiarly absent from the services field</u>. Yet they are the fields which show a very considerable increase in prices.

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Now, you could put it in this way. Consider the fields which show no productivity improvement, like the services field -- and I may say that I belong to it. I am a professor of

economics and I teach to about the same number of people in the same bumbling way as I did twenty years ago, with the result that college tuition has been one of the most explosive items in the cost of living index and will continue to be so. You may say that in the absence of any cost-push in a really ideal flexible world, the corporate sector which produces goods and has a considerable improvement factor in productivity ought to have a massive reduction in prices. No, scratch out the word "massive"; they ought to have a considerable reduction in prices. So that overall prices would average out to approximate stability, or to barely a one per cent increase.

That is asking quite a lot of a modern industrial society, although in the realm of agriculture, when government does not intervene for the purpose of changing the free market allocation of income, you often do get just such price reductions large enough to outweigh the price rises in the service industries.

COMMISSIONER GIBSON: Professor Samuelson, perhaps I might ask a question arising out of your remarks. Do the problems in connection with controlling or reducing the cost-push inflation lead your thinking in the direction of the development of some wages policy or administrative price policy? Is that the way in which you see a solution, or do you see any light in that at all?

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that any of the suggested solutions of which I have heard are likely to solve the problem. I even think of many of them that they might do more harm than good. I would not regard the dilemma as a malignant disease; but it is a problem.

To use the image of medicine, if you diagnose a disease and sense the need for a cure for it, but you have not anywhere in the laboratories such a cure, then that is like the state of my mind with respect to this problem.

COMMISSIONER GIBSON: We have had suggested to us that if monetary fiscal policies are reasonably strong in the next decade, say, in view of the outer balance of productive forces in the world and closer balance between demand and supply, this might become less of a problem provided there is no additional strain in the way of overdoing monetary and fiscal expansion. Is that sensible?

PROFESSOR SAMUELSON: I think it is possible. Do you remember Mr. Micawber who was always waiting for something to turn up? I think we can occasionally wait for something to turn down. Per Jacobsson, a prophet not without honour, has said that we are facing a new era of deflation at the moment. We have certainly seen this in the important realm of staples. Colin Clark predicted that in 1960, after the war, there would be a massive increase in the prices of primary products. He said that terms of trade would move a great deal in their favour; he predicted that in 1943 or 1942, if I remember. Right after the war

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One thing about the terms of trade between primary products and others is that they do fluctuate. There are long-term tides in the affairs of man, so that with a little luck the problem of cost-push or of mild secular inflation could become less of a tension.

If I may give a concrete example, in the United States we have just been in rather a happy state if you look only at the price index. For the last couple of years the wholesale price index has been levelling off, if not falling. The increase in consumer prices has been quite moderate. But this does not re-assure me in the slightest, because although I will not say we have been in a major depression, we have been running at too low pressure.

By running the American economy in a sluggish way -- and I do not mean in the sense of mild Paishism, which says in Britain that the unemployment rate should go from 1½ per cent to 2 per cent -- at 7 or 6 per cent unemployment, you will not have the same cost-push. But that is no way to run a railroad either.

COMMISSION GIBSON: That is; the cure is worse than the disease in this case?

PROFESSOR SAMUELSON: In some measure that is true, I think.

COMMISSIONER BROWN: Professor Samuelson, you did make a remark in your observations that Paishism would not work in the United States. Is that

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because of some rigidities in the economy, or what?

PROFESSOR SAMUELSON: It would be a very long story to try to analyse the mechanism of what I have called cost-push. I think I prefer the expression "sellers' inflation" as against "demand inflation" because that suggests the responsibility is broadened. I think it is naive to attribute cost-push simply to organized labour. It is very understandable that unions will try to get an increase in money wage rates, and that union leaders will try to get such an increase; but it is naive to think that leaders push and that the rank and file do not push. The late Professor Slichter, an intimate student of unions, said that union leaders lost their jobs more often through a vociferous minority in the rank and file who think that the leaders are not being active, than because they are too active. Sellers' inflation is a phenomenon which also involves management. The Phillips curve is not merely a reflection of labor push. There is involved not only the unions but also the weak or strong resistance of management, and sometimes it looks almost as if unions are pushing against an open door in these matters.

More than that, let me give you an example in the educational field. At M.I.T. my secretary is not a member of a union. I do not think there is any particular danger (if that is the right word) that she would ever become a member of a union. But she must get a money wage increase and "improvement factor"

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increase along with everybody else. If you ask why we pay more, it is because otherwise the quality of our people will gradually diminish in recruitment, and so forth. If I buy a pair of shoes and I put them on, the shoes give me service as a piece of leather. But in the case of a wage, the service you get depends on what you pay. If you do not increase wages and labour is made unhappy, you may actually lose in terms of cost. All in all this tendency toward sellers' inflation and cost-push is rather deep and widespread in our system, even involving some of the best aspects of our system.

Take, for example, unemployment compensation. Very few men of good will think such improvements are bad. But it is a fact that Paishism, at least in the extreme degree, depends on a change in people's attitudes because they are out of work, as when the man at the factory gate actually competes hard against the worker inside the gate. But that does not happen so much any more. Unemployment is not quite the uncomfortable thing it was. Mind you, it is no bed of roses, but it is not what it used to be. All these, I am afraid, have an adverse effect on the Phillips curve -- and I use that technical expression as a short-hand for certain behaviour patterns in modern economies. It is not peculiar to any one country. I think Western Germany will find itself with a worse Phillips curve in the years ahead than it has had before. And I used to envy them for their Phillips curve in the decade of 1950's.

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COMMISSIONER LEMAN: Professor Samuelson, I should like to go back to your refusal to call it a break-down of the market economy. Perhaps the word was a little strong, but it is a symptom of the system of balances that we count on in a market economy not working in that case, is it not?

PROFESSOR SAMUELSON: Yes.

COMMISSIONER LEMAN: I meant break-down in that sense.

PROFESSOR SAMUELSON: Yes.

THE CHAIRMAN: There is one point to which I should like to come back for a moment. You were discussing friction which arises on occasion between the central bank and perhaps Congress, or some other public body of that kind. I suppose that it is not a unique situation in central banking. Is it not the conflict which arises so often in this world between the experts and the amateurs? You have the central bank,which is a body of highly trained men in a very specialized profession; on the other hand, you have legislators, some of whom may be experts, but no doubt most of them are not experts in this particular field, and there is always a conflict. I do not know whether there is such a thing as a formula for resolving the situation, but it is something with which we have to live, is it not?

PROFESSOR SAMUELSON: I think that the whole political process can be expected to involve certain adversary procedures and differences of opinion. I would think that a central banker who

never had any trouble with the government was probably a central banker who was not doing his duty. On the other hand, I think it is a little more than a question of expert versus amateur, because that conflict can arise everywhere. The central banks' conflicts with government, the big ones typically, are almost always the conflict between those who want more expansion and those who want less. It is between those who want more attention paid to the internal and the external value of the currency, and those who prize production more. If it were just expert versus amateur, I suppose 50 per cent of the time the central bank would be on one side and 50 per cent of the time it would be on the other side. But today I think we see a more systematic pattern than that.

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In the case of that Australian crisis, which I mentioned in the 30's, Australia wanted to do what almost every country in the world was doing at that time, namely to undertake a deliberate expansionary policy against the great depression. Had I not heard about this case and had somebody propounded the question to me that there was conflict in Australia and who was on which side of the conflict, I think I would have made a pretty accurate guess as to who was on which side. So, it is a special kind of conflict.

I do not know how you define an expert, but if you would be kind enough to include a person like myself as an expert ---

THE CHAIRMAN: Oh, yes.

PROFESSOR SAMUELSON: In doing so you would blanket in quite a number of academic economists.

THE CHAIRMAN: You might include me as an amateur.

PROFESSOR SAMUELSON: Taking the fashion of academic economists as it is now in the United States I think it is fair to say that those of us experts who have a Freudian love for the Federal Reserve and think of it and henpeck it all the time point our general henpecking and nagging in the direction of regarding them as being too concerned about price stability and too willing to tolerate a sluggish economy.

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an example, has repeatedly said that he is not for a sluggish economy, but he thinks price stability is the indispensible way of getting a sustainable high employment economy. So, it is not merely a difference in price and other goals, but is also a difference of opinion as to mechanism.

The Lord knows that in the United States government itself there is no one opinion. One would expect that if there were a closer co-ordination between the central bank and the governments of the world, as I have in effect advocated, there would still be a difference of opinion but I think ----

THE CHAIRMAN: Well, there would be a difference of opinion within the banking circles as well as outside the banking circles. You have differences of opinion everywhere.

PROFESSOR SAMUELSON: Yes, but in the end who is to win in the show-down? That is the problem which was not clear in the tradition of central banking in former times. I think it has been clarifying itself.

THE CHAIRMAN: Could you say anything about this as to the general improvement of understanding on the part of those who are concerned with policy with respect to the function of central banking, and so on? I am thinking of the legislature on the one side where legislators are concerned with the views of people who think that money is too tight and they do not like it--- the shoe pinches, and that it is the view they present. Do you think there is any

an example, has repeatedly said that he is not for a sluggish economy, but he thinks price stability is the indispensible way of getting a sustainable high employment economy. So, it is not merely a difference in price and other goals, but is also a difference of opinion as to mechanism.

The Lord knows that in the United States government itself there is no one opinion. One would expect that if there were a closer co-ordination between the central bank and the governments of the world, as I have in effect advocated, there would still be a difference of opinion but I think ----

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improvement, that there is a chance of much improvement for greater maturity in the thinking of the mature legislator in problems of this kind?

PROFESSOR SAMUELSON: I think that these things go in cycles, and I detect a little improvement. I do not want to use pejorative words but when a "Populist" philosophy is very dominant in legislatures you have the greatest friction. At a time when that particular philosophy is not rampant in the electorate you have less friction.

Mr. Dooley said that the United States Supreme Court follows the election returns. That is a joke. It is somewhat true that the central bankers of the world also follow the election returns.

Montagu Norman -- and he is one of the last who had quite a lot of unilateral power -- thought he had the right to nag; in fact he had the duty to nag and he had the right to protest, and publicly protest. I have now ceased to quote him, but he also had the right, which every public servant has, of resigning in a huff and with a blast. I think that is a very important right. It is a right, by the way, which any civil servant has, and which a political figure within government has. If I were drawing up a constitution I would put in some specific features on how to handle conflicts not because the details are important in their own right, but to set up a machinery for dramatizing issues. But in the end the central banker would have to bow to the will of the responsible elected officials.

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COMMISSIONER LEMAN: Perhaps we should put a rule in that central bankers be prohibited from holding any money assets or any near-money assets at all.

PROFESSOR SAMUELSON: Are you thinking of conflict of interest in the person himself?

COMMISSIONER LEMAN: Well, he might have a bias.

PROFESSOR SAMUELSON: I do not think that is really a serious problem, but we have a rule, as you know, that the Secretary of the Treasury cannot hold government bonds. He is the only man in the United States who is not personally allowed to hold any government bonds. We also have a rule for government officials that sometimes they must not control common stocks. I will be somewhat facetious, but instead of getting out of common stocks perhaps they should be made to get into a balanced mutual fund so that they would remain part of the human race. That would be a more neutral state for them to be in than holding only money or gilt-edge type of instruments.

COMMISSIONER LEMAN: I was not being too serious myself with that question.

COMMISSIONER GIBSON: I should like to ask Professor Samuelson a few questions about the effectiveness of monetary policy and how it works. You say at the beginning of your memorandum that it has great potency to stimulate, stabilize and depress a modern economy. You go on later at pages 11 and 12

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to point out that a monetary policy is more effective in some circumstances than in others. You point out that when it is used vigorously in a restrictive sense it can be very effective and possibly too effective at times. You also point out that there is the difficulty, when it is being used for restrictive purposes, that a little may not have much effect, but that after a while it will suddenly take.

You also make it clear on the other side that it may be very difficult for a monetary policy to be effective in real depression conditions. What I am wondering is how you think it actually works? Does it work through interest rates, and what parts of the economy does it particularly affect?

PROFESSOR SAMUELSON: I had intended to have a whole section on that subject with headings such as Open Market Operations, Discounting Operations and Reserve Ratios, but again the clock and my schedule did not permit me to get to that. Therefore, I would be glad to give my views on the subject.

First, may I say with respect to one aspect of the question you asked, namely, whether a little-money monetary policy does not have much effect but a bigger one can create catasmic effects, that was not my opinion. What I mentioned was that such a view could not be dismissed as illogical and impossible, but in point of fact I do not think that has been our experience. I do not want, therefore, to press that as my view; indeed I wish to express some skepticism about it.

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When I speak of conventional monetary policy, I have in mind primarily the open market operations, which for the American economy is the important weapon. I also think it is the important weapon for the British economy, although in the British economy it is aborted to some extent by the discounting facilities that are available. I do not wish in the presence of experts on the Canadian scene to say anything about the Canadian situation because of my ignorance. This particular set of operations is primarily, important because it affects the interest rate structure and the availability of credit.

It has a secondary importance which I do not want to belittle because it also affects the valuation of assets. When interest rates are high the price you can get for the real assets you already own is low, you feel poorer and you will consume less; and, as a businessman, you are less liquid and less free to invest. Its primary function is the effect it has on the terms of trade between the investment of a reserve and the return of that reserve in fruit at some later date. By the "interest rate" in this context I do not mean simply the bill rate, I mean the rate on gilt-edge long-term government securities.

The profit rates which businessmen would seek, and which they will often insist upon getting, are not in the order of magnitude of 2.9 per cent, even though in the New York money market at this time the bill rate is about 2.9 per cent. They

may be on a before-tax basis for a certain kind of corporation, 12 per cent. However, it is an empirical fact that when you engineer a bill rate of 2.9 per cent as against 4.9 per cent, the effective profit rate which businessmen will have to get may go from 12 per cent to 18 per cent. I think if you were to interrogate businessmen you would often get denials on this. But my experience in talking to businessmen and looking at the figures and in thinking about how I would react in their shoes, suggests to me a lot of things that pay at 12 per cent just do not pay at 20 per cent. The argument which I must fight against is very familiar to me because I myself at various stages in my life have believed in it to a considerable degree, namely, "Well, what is the effective interest rate on anything?" As a consumer it does not matter to me what the interest rate is, and I spend about the same fraction of my income independently of it.

Some people would take the following view: With respect to business, for very short-term assets, the interest is not a very great cost. For very long-term assets -- and I am almost quoting directly the words of Professor J. R. Hicks of Oxford University -- the uncertainty is so dominant that the interest rate washes out. That leaves you a razor's edge of something that is between a long-term risk investment and a short-term investment, and you cannot do much operating on a razor's edge. I think that view is pretty substantially correct with respect to a short-term carrying of inventories.

may be on a before-tax basis for a certain kind of corporation, 12 per cent. However, it is an empirical fact that when you engineer a bill rate of 2.5 per cent as against 1.5 per cent, the effective profit rate which businessmen will want to get may go from 12 per cent to 15 per cent. I think if you were in [illegible] business yourself you would [illegible] when you decide on this. But my experience in talking to businessmen and looking at the figures and in thinking about how I would react in their shoes, suggests to me a lot of things that pay at 12 per cent [illegible] do not pay at [illegible] per cent. The argument which I make here [illegible] appears to be very familiar to me because I myself at one time [illegible] in my life have believed it to a very considerable degree, namely, "Well, what is the effective interest rate on investment?" As a businessman it does not matter to me what the interest rate is, but I cannot think [illegible] of it.

Some people would make the following point: With respect to business, how many short-term rates, the [illegible] is not a very good test. But most long-term [illegible] -- and I am [illegible] quoting directly the words of Professor J. R. Hicks of Oxford University -- the [illegible] is so constant that the interest rate matters not. That leaves you a [illegible] case of [illegible] that [illegible] a long-term [illegible] investment and a short-term investment, and you [illegible] to [illegible] on a [illegible] edge. I think this view of policy is [illegible] consistent with respect to a [illegible] long-term [illegible] of inventories.

Sir Ralph Hawtrey, one of the most renowned experts in our age on monetary policy and central banking, has always insisted that there exists somebody called the trader, one who carries interest on money. This chap is a very shiftable fellow as to the amount of inventory he will hold, depending on expectations of interest rates and the actual interest rates. I cannot profess to be an expert on the English countryside but I cannot find this fellow in the American countryside.

But often a businessman is concerned because he cannot get adequate bank credit and finance at the going rate. And such credit availability, or unavailability, is correlated with movements in the interest rate structure.

I think for long-term investments the factor of uncertainty is very important, but it is quite wrong to think that it washes out the interest rate factor. I have studied a great number of prospectuses of toll roads and bridges and it makes all the difference in the world, particularly for the promoter, whether he can make a million dollars if the capital that is available to him is available at, let us say, an 8 per cent rate or whether as a promoter the capital is available to him only at a 20 per cent rate. It may seem shocking to talk about 20 per cent rates, but if one reads the Wall Street Journal very carefully and follows the fortunes of companies like -- well, perhaps I should not name any particular names -- one will find

that some companies which build our biggest sky-scrapers and grandiose hotel projects are paying 20 per cent rates for money in many periods. You have got to be awfully smart and have an awfully good deal to be able to make money when you are paying off your borrowed money at 20 per cent.

So far as productive investment is concerned, I think that the longer the run that takes place the more you will get a choking off of investment at high interest rates, and a coaxing out of investment at low rates.

As I qualified myself in my paper -- you must remember that I am a professor, after all, so I do qualify my remarks -- there are deep depression times when there is not much potency in conventional monetary policy in either direction. I do not think we are in those times most of the time. One of the greatest challenges, I think, to the American system -- and here is where the central bank will have direct responsibility -- is to find means whereby we can get a deepening of capital. Can we move from projects that promise a 30 per cent return down to projects that promise a 20 per cent return, down to projects that promise a 15 per cent return, if that is the way the wind is blowing and technological change is not throwing up 30 per cent projects? We have to ask ourselves that question because in our kind of capitalistic system we want to behave well, not only in the sunny weather but also when the sun is not shining. I do think we need to get business

concerns to set their sights down lower and lower. They do gradually learn from experience,and they know that rather than sitting on their hands they should do something, and that it is better to get an 8 per cent return than to get no return at all.

I think it is here that the central bank has a great role to play in monetary policy . I have not commented on credit availability ---

COMMISSIONER GIBSON: Before you go on to that may I ask if you think that gradual changes in interest rates of modest proportions upward or downward have a fairly wide effect on long-term investment decisions, or is it a pretty narrow margin that these changes work in?

PROFESSOR SAMUELSON: I think that gradual changes in interest rates have gradual effects on investment over a fairly wide area, but the degree of those gradual changes increases with the time that is allowed to elapse. The width of the effect also becomes greater in time.

In saying this I do not mean to suggest that you can expect an increase in interest rates to affect every activity in the same way. Housing interests will come to our Congress when money gets tight and say: "We are affected more than the wholesale drug trade, and that is unfair". I will not agree with that. It would be wrong to think the purpose of an interest rate policy is to cause a one per cent reduction in everything, because at a lower rate of interest certain changes in the

composition of the economy are what are required for efficiency, and to fill the needs of the public.

COMMISSIONER GIBSON: In other words, you say there is more doubt about a long-range decision and, therefore, more reason why it should be postponed for the time being?

PROFESSOR SAMUELSON: Yes, and even in a world of certainty a high interest rate is an indication that society is not in a position to lock up its resources for 50-year periods as against 25-year periods. A country like India should by no means think it should produce houses of the durability of houses in the United States, because that country has a different capital scarcity. Times of great capital stringency (for example immediately post-war), when a lot of things ought to be done, then probably schools -- and I am thinking of schools in Cambridge, Massachussetts, and where I live in Belmont, Massachussetts -- ought to be portable schools; they ought to be temporary structures with some of the disadvantages that that implies. Later on, when society, so to speak, gives the go-ahead signal to deepen its capital, these inadequacies can be corrected.

The interest rate structure, including the imperfections of society that create the availability, is an appropriate signalling device. Although it is wise it is not perfectly wise.

COMMISSIONER GIBSON: And it is not discriminatory, in a sense?

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COMMISSIONER [illegible]: In other words, you say there is more doubt about a long-range decision and, therefore, more reason why it should be postponed for the time being?

PROFESSOR [illegible]: Yes, and even in a [illegible] containing a high interest rate is an indication that country is not in a position to look at its estimates for longer periods as against [illegible] periods. A [illegible] like ours [illegible] we would think it should presume because of the [illegible] of [illegible] in the United States, [illegible] that country has a different capital scarcity. [illegible] of [illegible] ([illegible]), [illegible] things ought to be done. [illegible] -- and I am thinking of [illegible] in Cambridge, Massachusetts, and where I live at Belmont, Massachusetts -- ought to be [illegible] [illegible] ought to be temporary [illegible] with some of the [illegible] that implies. Later on, when [illegible], as we know, after the [illegible] [illegible] its [illegible], those [illegible] can be [illegible].

The interest rate structure, including the [illegible] of [illegible] that create the availability, is an appropriate signalling device. Although it is wise it is not perfectly wise.

COMMISSIONER [illegible]: And it is not discriminatory, in a sense?

PROFESSOR SAMUELSON: The English language is very interesting. "Indiscriminate" and "discriminatory" come from the same root, and one sounds bad and the other sounds bad in the opposite sense. I would say this is a discriminate thing. It is not arbitrarily discriminatory.

Now, in the short run, given our market imperfections, there are special problems associated with the availability of capital to large business as against small business, and perhaps what is of more importance is the availability of capital to established business, whether it be small or large, as against the availability of capital to new business. Even that is not completely arbitrarily discriminatory because when capital is very scarce -- I am speaking metaphorically -- society cannot take risks with respect to untried projects that it could properly take at another time. So, part of that discrimination is discriminate, but it is not arbitrarily discriminating.

COMMISSIONER GIBSON: That is very interesting. Would you like to go on to the question of availability of funds?

PROFESSOR SAMUELSON: Yes. With respect to the availability of credit I think that that is an important mechanism in the short run. I ought, though, to say that I have testified before Congress at some length on this subject, and in that testimony I have pooh-poohed the notion that it is only through credit availability that interest rates work.

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I will supply your secretariat with the proper reference if you would like me to do so. But in the short run I think it is an important mechanism.

It works in this way. In my country it is very common for a commercial bank to have an interest rate of 6 per cent on a commercial loan. That will hold good without variation for three years, or maybe ten years or fifteen years. It will also hold as between a very substantial and reliable company and a less tried and true company.

If you then look for the effect of Federal Reserve policy on the interest rates charged to borrowers you might be excused for thinking that there was no effect -- that the rate was always 6 per cent. But if you go below the surface you will realize that there are compensating balances which are required from different companies, and in different degrees. If the Federal Reserve engineers a tightness of the bill rate from 2 per cent to 4 per cent, the chances are that a borrower in the Boston area, who had to keep only a 10 per cent compensating balance previously, will now be asked to keep a 30 per cent compensating balance. The true cost, of course, of the borrowing is 6 per cent on the whole sum, but how much of it do you have free to use for yourself? If you have to keep a 50 per cent compensating balance then the interest rate would be equal to 12 per cent per annum. There are many devices of that sort that are concealed, and yet

there is not a simple rationing. It is rather like the auction market in that you do not see the true price.

We do not have in my country the custom of having rates geared to the discount rate so that the Federal Reserve can automatically on one day, by changing its discount rate, change the terms charged by the banks to a wide number of borrowers. We have a man-made device which is a private enterprise device, and that is the so-called prime rate.

I think a number of customers find themselves in a certain relationship to the prime rate. The prime rate is a cartel-like rate set up by the principal banks for the so-called best borrowers. Even it is a signalling device, but it is variable because at certain times my medium-sized successful company will be a member of the club and will be able to borrow at the prime rate, but when money is more stringent I might find out that I am not a charter member of the club and I no longer qualify for the prime rate. It is a complicated system.

We have the commercial paper market, and when the banks are being very sticky, and are out of tune with the market, companies will go into the commercial paper market, where the rate is very much like an auction rate.

All in all, I would argue that there are in the short run very substantial and dramatic effects

from credit rationing, or the availability of credit. The longer the run for a certain period the more these things merge into actual pecuniary charges, so it is more as if the rate were going up. There is a certain amount of unevenness in the process and I think certain things could be done about it; but the principal mechanism,I think, operates through the whole interest rate structure.

COMMISSIONER GIBSON: But, so far as the effect of monetary stringency on inventories is concerned you would say that that would work more through availability or more through actual changes in the cost of money?

PROFESSOR SAMUELSON: I would say that so far as inventories are concerned it probably would be more related to availability.

There is another factor. I cannot call it moral suasion, but it is the sort of thing that applies typically to a small business or a medium-sized business when it is in a certain relationship with a banker. That business gets advice from the banker, and much of that advice is like the advice received from an uncle. You can take it or leave it. But, the fact is, that bankers supply money and when you, a car dealer, let us say, are told: "We are going to drop the boom on you if you keep this number of cars", you jolly well begin to discount your cars and order less. There is that sort of suasion factor which is backed up by a certain amount of economic power, and I think it is quite

from credit rationing, or the availability of credit. [illegible] these things merge into actual pecuniary charges, so it is more as if the rate were going up. There is a certain amount of uncertainty in the process and I think nobody [illegible] would be sure about it. [illegible]

COMMISSIONER [illegible]: But, so far as the effect of monetary stringency on inventories is concerned you would say that that would work more through availability of money than through actual changes in the cost of money?

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important.

COMMISSIONER GIBSON: In other words, bankers' views about expectations are transmitted in a fairly effective way?

PROFESSOR SAMUELSON: Yes, including the banker's view of the leanness of his liquidity position, which the Federal Reserve has direct means of affecting.

COMMISSIONER GIBSON: How much do you think these reactions work on expectations rather than immediate effects?

In other words, when interest rates go up, or in one way or another the cost of getting money goes up a bit, and money becomes a little harder to get, is it just this that causes people to change their views a little, or do they say that this means a different economic environment, perhaps, and it is a signal that money may be harder to get?

PROFESSOR SAMUELSON: I think in the very short run there are significant announcement effects of changes by the authorities which change the expectations of the participants in the economic scene, and which could have important effects. But, I think many of the economists of my generation tend to exaggerate the expectation effect.

I will call your attention to the review by Professor J. Gurley of the Radcliffe Report in the American Economic Review. In fact, I made reference to it in my submission. One of the things he pokes a little fun at is that the Radcliffe Report

generally.

COMMISSIONER [illegible]: In other words: [illegible] [illegible] [illegible] [illegible] a fairly effective way?

PROFESSOR [illegible]: Yes, including the [illegible] view of the [illegible] of his liquidity position, which the Federal Reserve has direct means of affecting.

COMMISSIONER [illegible]: How much do you think these [illegible] [illegible] rather than [illegible] effects?

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took much too seriously the view that expectations and intentions are what cause changes rather than real actions. It is rather like the Mikado: when he said a man was to be executed it was as good as done, and therefore it was done. My view is that you do actually have to change the amount of liquidity in the system.

I think that announcements affect expectations if people have learned that these are the correct signals of changes in the actual availability of funds, and they anticipate them a little bit; but let the central bank start making announcements which it does not follow through, then it will be like King Canute and the tide. You can tell the tide what to do but it will pay no attention to you. People will soon learn not to pay attention to your announcements.

I do not think that it is a sort of bootstrap operation, that by making people think monetary policy is going to be tight they will act as though it is tight, and you do not really have to tighten it at all. You can catch them once on that sort of operation, perhaps, but not repeatedly.

COMMISSIONER GIBSON: We have had it suggested to us that in some other countries -- not the United States-- it is only major and striking changes in monetary policy that have much effect on the business community's attitude, and that these small changes edging this way and that way have comparatively little effect. Does this make sense

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COMMISSIONER GIBSON: We have had it suggested to us that in some other countries -- not the United States -- it is only major and striking changes in monetary policy that have much effect on the business community's attitude, and that these small changes edging this way and that way have relatively little effect. Does this make sense

from the standpoint of the United States, in your thinking?

PROFESSOR SAMUELSON: I think that the accumulation of small effects does not dissipate the effect. I do not believe, in other words, in the threshold phenomenon -- that if you sprayed paint a little drop at a time all over this table you will not even see the difference. What you will see is over a great expanse a very thin difference everywhere.

I am of the opinion, though, that the zealots for monetary policy, particularly those who argued against credit when the Federal Reserve was trying to get its freedom, are wrong when they say that when you let the price of bonds get to $97 you have got the tight monetary policy you want. I think the evidence is against that. It is not that there is any optical illusion. If I could lapse into my academic manner and draw a curve of the relationship of the degree of monetary policy to its degree of effectiveness you would see that it is not that there are threshold effects but that there are corners in the curve, and discontinuities. It is rather that the curve has a substantial slope, and it takes a considerable interest rate change to have a considerable effect. You do not have great effects from small things. Technically speaking, you do not have an infinite and real elasticity of response in your functions and schedules and diagrams to the effects of

from the standpoint of the Federal budget, in your thinking?

PROFESSOR SAMUELSON: I think that the accumulation of small effects does not duplicate the effect. I do not believe, in other words, in the threshold phenomenon -- that if you spread paint a little drop at a time all over this table you will not even see the difference. What you will see is only a steady movement in very thin difference increments.

I am of the opinion, though, that the critics of monetary policy, particularly those who opposed applying credit when the Federal Reserve was trying to get its position, are wrong when they say that when you let the price of bonds go to 2 1/2 you have got the least monetary policy you want. I think the evidence is against that. It is not that there is any optical illusion. If I could have this my favorite manner and draw a curve of the relationship of the degree of monetary policy to its degree of effectiveness you would see that it is not that there are threshold effects but that there are corners in the curve and discontinuities. It is better that the curve has a substantial slope, and it takes a considerable increase size change to have a considerable effect. You do not have great effects from small things. Technically speaking, you do not have an infinite and real elasticity of response in your functions and schedules and diagrams to the effects of

spending activity by various changes in the level of central banking activity. Even at the best of times I do not think you have that sort of effect.

--- Short recess.

THE CHAIRMAN: We shall now resume. Mr. Gibson?

COMMISSIONER GIBSON: Mr. Chairman, when we broke off Prof. Samuelson made a number of interesting comments about how monetary policy works or how changing credit in monetary conditions works, and he left me with the impression that the consumer isn't very much affected in this pattern and particularly that long-range investment decisions and, to some extent, the inventory decisions, were the operative parts of this phenomenon.

If this is fair, I would like to go on and ask you how you think attitudes and views about liquidity affects spending decisions? This is another way of talking about the same thing, really, but we have heard a lot of broad liquidity concepts since the Radcliffe Report and I wonder if you would care to say a bit about how you think people view this question and if it does affect their spending decisions?

PROFESSOR SAMUELSON: May I first say that the consumer, as house owner and ower, is quite considerably affected by credit, but as a purchaser of cigarettes and breakfast foods and even of washing machines he is probably not so importantly affected. The state of liquidity is an important variable, I believe, for investment decisions, and therefore it is important. I think that the central bank when it sticks to conventional operations is, to some degree, altering the distribution of liquidity

rather than changing its total.

For example, if you confine yourself to the most conventional of central banking operations, which is the purchase of a short-term government security, like a 90-day instrument, the central bank is merely putting out cash and taking in a near money substitute. The total of liquidity is probably affected, but it is not affected substantially. If the central bank were very unconventional -- which I am not suggesting here -- and dropped money from aeroplanes, aside from any interest rate effect, there would be a very substantial effect upon liquidity and upon the asset structure and that would show itself in operations. If this could be expected to be a repetitive act, I would almost transfer it to the area of flows rather than stocks, because each person would total up his income and say that you could haul around a certain amount of money as a labourer or that I will get my dividend cheque by mail or by manna from heaven, and this would have very substantial effects. But the conventional thing which the central bank does is exchange one kind of asset for another.

A reserve ratio change, which can have a very potent and dramatic effect in the United States is used only at infrequent intervals, and that can have a strong effect upon liquidity. I included, therefore, in my interest rate effects, which I enlarged upon earlier, a certain amount of these liquidity effects,because it is by affecting the

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stocks of different assets or, if you like, the liquidity position of the community, that these interest rate changes take place in the market place.

I have never criticized the Radcliffe Committee for its emphasis on liquidity, but I have criticized it for thinking that that emphasis on liquidity in some way negated the potency of ordinary central banking. What it does negate is simply quantity theory reasoning and rules for the central bank. The interest rate effects I have been speaking about are very closely related to liquidity effects.

Now, I should perhaps point out that when you get manufacturing corporations depending very much upon internal finance and being very liquid in that sense, you will have a time when the same patterns of central banking activity will have less effect upon their investment spending because such corporations work through their own banker under those circumstances, and liquidity enters in that particular way.

If I deal with the fundamentals, I would also have to point out that the way we financed World War II drastically altered in the post-war period the total amount of cash in the community, plus the total amount of assets in the form of government bonds. Now, it wasn't a mere swap because the typical American individual, when he owns a government bond, doesn't say ~~to~~ himself, "True, I own this bond, and as a person and as a taxpayer

I will have to pay the interest on it and hold it for a certain date and therefore when I draw my balance sheet of net worth I will cancel out my ownership on the government instrument by my obligation as a citizen". If he did this, then there would be no massive increase in liquidity, but there was a massive increase in liquidity and it was related to the wartime central bank and treasury activities. I don't therefore, want to go on record as putting emphasis upon the existing rate structure in a way that denies that liquidity has an effect.

There are also some independent liquidity factors, and I will make one last remark in this connection. In the years after the war in connection with the New York Federal Reserve Bank, and particularly associated with the names of Alan Sproul, Professor J. H. Williams of Harvard University and the New York Federal Reserve Bank, and Dr. Robert V. Roosa, then director of research and vice-president for the New York Federal Reserve, and now under-secretary of the Treasury, there grew up a notion -- almost a mystique I would say,-- that the central bank can accomplish much by creating uncertainty. In addition to the pattern of interest rates which you read about in the New York Times in the morning, there exists varying degrees of uncertainty. What you don't see is that Alan Sproul, like a Toreador, is waving a red flag so that the bull can't understand which way he will go. So superimposed upon that same structure of interest

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rates is a degree of uncertainty which makes people feel less liquid and therefore has a restraining effect. In that sense of liquidity, of uncertainty about changes, there are some effects. I think the New York Federal Reserve school exaggerated them, but perhaps it was in a good cause at that time.

COMMISSIONER LEMAN: May I ask a question at this point? After the war the holding of government bonds by the public or by a citizen who would draw up his balance sheet, I thought you said that there could not have been a purely rational analysis of this situation in increased liquidity because he should have realized that he would have to pay for the services and the fact is that on any such balance sheet which he would make he considersthe obligation to pay for that as a long-term sort of obligation, whereas he still considers the bond as an asset?

PROFESSOR SAMUELSON: I want to be absolutely non-committal in terms of whether it is rational or irrational for him to do what he does, but I do mean to assert that he doesn't treat as a liability the full equivalence of that asset. If you want me to comment on whether I think it is rational ----

COMMISSIONER LEMAN: He is bound not to treat it as a current liability?

PROFESSOR SAMUELSON: Yes.

COMMISSIONER LEMAN: But he may treat it as a liability, if he wants it to be a liability, but not a current one; he will treat the bond as a

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CONGRESSMAN LEHMAN: He is bound not to treat it as a current liability.

PROFESSOR SAMUELSON: True.

CONGRESSMAN LEHMAN: But he may treat it as a liability, if he wants it to be a liability, but not a current one; he will treat the bond as a

current asset?

PROFESSOR SAMUELSON: I think I will put into the record now that you said it was rational for him to act in that way; I don't pass judgment on that.

THE CHAIRMAN: Yes, but the liability would be his and it would have to appear in his balance sheet whether he owned the bond or not.

PROFESSOR SAMUELSON: Yes. What I meant was the following. For a consolidated balance sheet of all the citizens in the community, _if_ it were true that those who owned bonds were matched by a recognition on their part of their share of the liability, and for those who didn't own a bond, the recognition of _their_ part of the liability, so that when we consolidated, the total of the liability equalled the total of the asset, and this conditioned each person's behavior; then, I don't think that the system could be regarded as being terribly more liquid than before. Whether it is rational or not, I don't believe that the community acts in that way. It acts as if it is richer than certain methods of accounting would suggest it really is, and that is why I say, -- without any moral judgment or any statement of whether it is rational or irrational -- that the American people came out of the war in an extremely liquid position. If you press me, I will comment on the rationality or irrationality of it, but if you don't press me, I will not!

COMMISSIONER LEMAN: I wish you would.

PROFESSOR SAMUELSON: I think as far as the individual is concerned, in the stream of history and knowing the way the nation keeps its books with respect to generations, and so forth, that a case can be made out that it is not irrational for me to disregard this obligation. I only keep in mind what _my_ tax rate will be in the next ten years, and what my income will be in making my decision. I don't go around with the load of the public debt on my shoulders, or when I look at my children I don't see a phantom public debt on their shoulders, and when I look at my phantom grandchildren -- who have not yet appeared -- I don't see them with a load of debt on them.

And the same problem could come about with respect to the issue of currency. If you don't think the society is a going concern, you should look at all the currency in the community, which is the non-interest bearing I.O.U.'s of the government. The answer to the question what is it payable in terms of is simply: it is payable only in terms of another I.O.U. The public debt is a sort of fiduciary issue.

All we think about in our lifetime is that you cannot take it with you, but before you go you can do something with it, and we take that to be a fact.

If you thought of society as having a declining population and liquidating, or if you want an exercise with respect to doomsday -- say that it is vouchsafed to you that an atomic bomb will fall

[illegible] as far as the 'individual is concerned, in the stream of history and knowing the way the [illegible] keeps its books with respect to [illegible], and so forth, that a case can be made out that it is not [illegible] for me to [illegible] this [illegible]. I only keep in mind what my tax rate will be in the next ten years, and what my income will be in making my decision. I don't go around with the [illegible] of the public debt on my conscience, or when I look at my children I don't see a [illegible] public debt on their shoulders, and when I [illegible] -- who have not yet [illegible] -- I don't see them with a load of debt on them.

And the same [illegible] could come about with respect to the [illegible]. If you don't think the society is a going concern, you should look at all the property in the community, which is the non-[illegible] bearing I.O.U.'s of the government. The answer to the question what is it possible to [illegible] [illegible]: it is possible only in terms of [illegible] I.O.U. The [illegible] is a sort of [illegible] [illegible].

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If you thought of society as having a oscillating population and liquidating, or if you want an exercise with respect to doomsday -- say that it is vouchsafed to you that an atomic bomb will fall

nineteen days from now at one o'clock -- some quite violent things would happen no doubt to the velocity of circulation of money under these circumstances, particularly if there was a division of opinion.

COMMISSIONER BROWN: If you once started on this you would have to take into consideration their share of the assets, too?

PROFESSOR SAMUELSON: Yes, but most of the World War II debt was incurred for the worthy asset of preserving our way of life.

COMMISSIONER BROWN: There are a few capital assets?

PROFESSOR SAMUELSON: Yes, government has quite a lot of assets.

COMMISSIONER BROWN: And some of these assets are liabilities in the sense of maintenance and so forth?

PROFESSOR SAMUELSON: Yes, it is like some of the savings my wife makes; we can scarcely afford them!

COMMISSIONER GIBSON: Isn't it true that when a business community issues a lot more short-term paper that this makes the whole community feel more liquid? There are two sides to that too. This short-term business paper and liquidity assets for a lot of people has an advantage but this can be restricted by the issue of paper which will offset ---

PROFESSOR SAMUELSON: There is the old joke about the island with no resources where everybody

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COMMISSIONER BROWN: If you once started on this you would have to take into consideration their share of the economy, too?

PROFESSOR SAMUELSON: Yes, but part of the World War II debt was incurred for the worthy asset of preserving our way of life.

COMMISSIONER BROWN: There are a few [illegible]

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COMMISSIONER BROWN: And some of these assets are liabilities in the sense of maintenance and so forth?

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COMMISSIONER JANSSEN: Isn't it true that when a business community issues a lot more short-term paper that this makes the whole community [illegible] more liquid? There are two sides to that too. This short-term business paper and liquidity assets for a lot of people has an advantage but this can be restricted by the terms of paper which will off-set ---

PROFESSOR SAMUELSON: There is the old joke about the island with no resources where everybody

lives by taking in each other's washing. I think liquidity is like that; we all live by the promises we make to each other and there is a kind of a social contract and social concensus, which is why I accept a Canadian dollar bill when you give me one. But suppose that at any instant in time everybody began to have doubts about it being a going concern, then you get an internal-drain crisis -- which we have had in history -- where you get a run on the banking system. It is interesting to me that in a simple statement to you I was mentioning what is, after all, probably the most important function of a central bank, but which is so taken for granted that we never even mention it any more -- that at a time of internal crisis, when people have doubts about the liquidity and soundness of a fractional banking system, the central bank is there if necessary as a legitimate counterfeiter to satisfy that demand. I emphasize this because there is no fractional reserve banking system that can liquidate itself if everybody wants his money simultaneously. That is, it cannot do it without the aid of the central bank. Since the time of Bagehot it has been recognized by experts and ever since 1935 it has been recognized by legislation that the function of the central bank is, in such a situation, to create the liquidity that the public wants. Of course, once the public knows it can get it, it typically doesn't want it.

COMMISSIONER GIBSON: You are emphasizing that liquidity is a state of mind rather than a

measurable clear-cut phenomenon?

PROFESSOR SAMUELSON: Yes indeed, because when we analyse liquidity technically we find it refers to two or three features and one, from the individual standpoint, is: is this thing transferable.

Now, there were some horrible mistakes made by the founders of the Federal System in 1913 in this respect; they thought that the most liquid asset imaginable was a 90-day or a 180- day promissory note from a local hardware merchant or a local farmer with the bank, whereas they thought that an 80-year government bond -- that is, a bond with a maturity of 80 years -- was one of the most illiquid things possible. Now, from the standpoint of transferability this is not true: You can sell government bonds on Sunday; that is, one bank can sell government bonds on Sunday. But one bank alone knows the credit-worthiness of its neighbour and his I.O.U. is not liquid in that sense. The founders had a grain of truth on their side: namely, that in ordinary eventualities, the cycle of repayment meant that the hardware dealer was supposed to get out of debt at the end of that period. (But any person who has lived in a small town knows what the actual facts are, that there was a renewal of these notes in many cases.)

Transferability from the individual view-point is an important aspect of liquidity and, of course, it is not the same for the group as it is for each individual. Transferability at a predictable

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Now, there were some terrible mistakes made by the founders of the Federal System in 1913 in this respect; they thought that the most liquid asset imaginable was a 90-day or a 60-day promissory note from a local merchant presented by a local farmer with the bank, whereas they thought that an 18-year government bond -- that is, a bond with a maturity of 30 years -- was one of the most illiquid things possible. Now, from the standpoint of transferability that is not true: You can sell government bonds on Sunday; that is, the bond can sell government bonds on Sunday. But the local dealer knows the credit-worthiness of the neighbor and his I.O.U. is not liquid in that sense. The [illegible] have a greater [illegible] on their side: namely, that in [illegible] eventualities, the cycle of [illegible] [illegible] that the hardware dealer was obligated to pay off the [illegible] at the end of that period. (Did any person who lived in a small town know what the actual [illegible] are, that there was a renewal of these notes in many cases.)

Transferability from the individual viewpoint is an important aspect of liquidity and, of course, it is not the same for the group as it is for each individual. Transferability at a predictable

price is another aspect of liquidity and here the 80-year bond is not as liquid as the 90-day bill. All these things are states of mind.

At a time during the 1930's when people were pre-occupied with the high money rates that prevailed in the 1920's, they felt that a return to long-term government bonds -- be it 30 years duration -- didn't seem like a terribly liquid thing to individuals and therefore there was this liquidity preference. I believe that the technical explanation is not a hard concept; it is a fluctuating thing and fluctuates with circumstances and also fluctuates with the induced activities and utterances of the central bank and it does have subsequent effects on certain kinds of spending.

COMMISSIONER GIBSON: Do you think it is possible to analyse in a useful sort of way the current attitude toward liquidity. We have had certain people before our Commission, business people, and we have asked them how they feel about this, and how their decisions are changed by a change in the degree of liquidity in their concerns and so on, and we got rather varied answers. There was not anything very clear about it. The only thing I got out of it was the idea that maybe they would move in the same sort of direction, although their habits were different under some circumstances. Is there anything you want to say about this? This is an area that does not seem to have been explored very well.

PROFESSOR SAMUELSON: I think that the

area is another aspect of liquidity and here the 20-year bond is not as liquid as the 90-day bill. All these things are shades of mind.

At a time during the 1930's when people were pre-occupied with the hard money notes that prevailed in the 1930's, they felt that long-term government bonds -- as it [illegible] -- didn't seem like a terribly liquid asset to individuals and therefore there was only [illegible] preference. I believe that the liquidity assumption is not a hard concept; it is a fluctuating thing and fluctuates with circumstances and also fluctuates with the [illegible] and [illegible] of the [illegible] that is [illegible] of certain kinds of [illegible].

CHAIRMAN [illegible]: Do you think it is possible to [illegible] a [illegible] way the current and [illegible] liquidity. We have had certain people before our Committee, business people and we have asked them how they feel about this, and how their decisions are changed by a change in the degree of liquidity in their economic [illegible], and we got rather varied answers. There was not anything very clear about it. The only thing I got out of it was the idea that maybe they would make it [illegible] sort of direction, although their habits were different under some circumstances. Is there anything you want to say about this? This is an area that does not seem to have been explored very well.

PROFESSOR SAMUELSON: I think that one

actual observed actions of business will not prove to be quite the same as their verbal utterances in respect to those actions partly because there is a certain amount of rationalization involved, partly because the form of the question is different and partly because of the fact that you don't have to be able to articulate what it is you are doing. I think the suggestions and the reasoning confirms the proposition that the more liquidity their business has the more willing it is at the margin to tie itself up in capital formation which uses up liquidity. If you have more of something to devote to a purpose you won't devote all of it there, because you want liquidity. But you will have a little more surplus liquidity and, therefore, you will invest more.

We have had some excellent statistical studies that throw some light on this. I would refer to Professors John Meyer and Edwin Kuh, who have a book on the subject, and it is their conclusion that a good deal of the investment behaviour of American manufacturing enterprises in a number of post-war years could be explained and related to the cash flow that comes to them through earnings plus depreciation and accruals. I think that recommends itself to our reason, as we think what we would do if we were businessmen and found some of the facts, but the relationship is not rigid. There is a time like now when there is a considerable amount of evidence that American corporations this year are in a rather liquid position from their cash flow

actual planning figures [illegible]

be quite the same as their verbal statements in regard to those matters partly because there is a certain amount of rationalization involved, partly because the form of the question is different and partly because [illegible]

[illegible]

line now when there is a [illegible] of evidence that American corporations this year are in a rather liquid position from their cash flow

viewpoints, and have not used up that liquidity by elaborate plant and equipment investment commitals. This suggests to me that at this time if the Federal Reserve eased there would not be as big a reaction to that degree of an easing as there would be at some earlier time when business liquidity seemed lean.

COMMISSIONER GIBSON: Thank you. I would like to now ask a few questions about velocity and near money, and things in this general area. You suggest in your memorandum that some changes in velocity are reasonably predictable, or may be reasonably predictable. You do not elaborate on this. Would you give me a better idea of what you have in mind there?

PROFESSOR SAMUELSON: Well, there are certain long-term trends in velocity which may be predictable. There are certain changes during the cycle. I should be surprised, for example, if in future business cycles in the United States, as traced out, say in the records of the National Bureau of Economic Research, you do not see that simple trend in the velocity of circulation of money with the cycle itself.

Now, the crucial question to which I was addressing myself was this. When the central bank makes a deliberate change, what can be said about the induced changes in velocity? It depends upon the circumstances, and under certain circumstances I think you can make a prediction. In almost all

circumstances except the deep depression liquidity trap that I mentioned, I think you can make the prediction that a change in velocity, whether it be upward or downward, but particularly if it were to be downward, will not in all probability be downward enough to wipe out the original expansion of M. The only exception I can think of would be if the central bank did something very unconventional and the effect of that were to paralyze confidence and set off, therefore, certain forces which would affect the velocity. I think that is an extremely rare situation.

Now, when I said the effect was predictable, I do not mean to say that if the central bank expands M today, and you look at the records tomorrow, you will find that the velocity did not follow. What I mean is, the effect which can be attributed to an increase in M itself. Most instances when the central bank is increasing the amount of money, if it is a good central bank, are in a time of decline -- in recession. Therefore, the velocity is probably declining and the centralbank is doing its little bit to offset that. But, if somehow you could make a controlled experiment to see what the change in velocity was compared with what it otherwise would have been, then I think you would find that in many stages of the cycle the velocity would predictably decline very little even though the amount of money were increased. There are other circumstances where I think the velocity would almost completely offset your behaviour. I should say that this is my opinion.

[illegible]

trap that I mentioned, I think you can make the prediction that a change in velocity, whether it be upward or downward, but particularly if it were to be downward, will not in all probability be drastic enough to wipe out the original expansion of M. The only exception I can think of would be if the [illegible] bank did something very unconventional and the effect of that were to produce [illegible] tions, certain forces which would affect the velocity. I think that is an extremely rare situation.

Now, when I said the effect was [illegible] I do not mean to say that if the amount of money increases M though, and you look at the measured velocity, you will find that the velocity did not decline. What I mean is, the effect which can be attributed to the increase in M itself. Most instances when the central bank is increasing the amount of money, if it is a good central bank, are in a time of decline -- of recession. Therefore, the velocity is probably declining and the central bank is doing its little bit to offset that. But, if somehow you could make a controlled experiment to see what the change in velocity was compared with what it otherwise would have been, then I think you would find that in most stages of the cycle the velocity would probably decline very little even though the amount of money [illegible] I think the velocity would almost completely offset [illegible]. I should say that this is my opinion.

At least one very respected and excellent economist, Professor Milton Friedman of the University of Chicago is of a different opinion. He is of that different opinion based upon his extensive historical researches on the subject covering practically a ten-year period. However, I still hold my opinion after having looked at some of his data.

COMMISSIONER GIBSON: One of the most interesting aspects of this, and one of the most frequent discussions before this Commission is in respect of the question of how far the increase in velocity will go, and that depends on your concept of velocity; and also the increase in the use of near money in a boom period where monetary policy is trying to seal things up; how far this increase in velocity and near money offsets the policies that the central bank is trying to pursue, and this brings the whole question of near banks and their activities into the picture.

PROFESSOR SAMUELSON: Yes.

COMMISSIONER GIBSON: I am very interested in that. Would you care to comment in this regard?

PROFESSOR SAMUELSON: I think it is natural and to be expected that when businessmen's velocity increases and when the central bank tries to put a restraining hand on that process the velocity will to a considerable degree increase so as to offset that restraining hand. What I think is wrong is to think that velocity will increase enough to offset it completely.

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PROFESSOR SAMUELSON: Yes.

COMMISSIONER GIBSON: I am very interested in that. Would you care to comment in this regard?

PROFESSOR SAMUELSON: I think it is natural and to be expected that when businessmen's velocity increases and when the central bank tries to put a restraining hand on that process the velocity will to a considerable degree increase so as to offset that restraining hand. What I think is wrong is to think that velocity will increase enough to offset it completely.

COMMISSIONER GIBSON: There will be a net gain as a result?

PROFESSOR SAMUELSON: There will be a net gain as a result and there is also a signal to the central bank for more of the same.

The important policy of a central bank is that it should feel its way. I think that Alan Sproul said "to probe the market"; you push more and more and if you haven't done enough you push further in that direction. You may overdo it because there are lags involved, but it is not necessary, to be an effective central bank, to do that through fiscal policy. It is not necessary for us to recognize, as professors of economy, any data; all that is needed is a strong proposition that if you move in this direction the effects upon the system will be predictable in this direction. Now, if in fact when you tighten money, velocity was guaranteed to increase enough to wipe out this money and 50 per cent again, you could live with that system. It would just be a central bank always operating in reverse.

During the war I remember there was a very famous Draper gunsight that had the great virtue that if it did not work you threw it overboard. There was one little problem with it. If you hunt ducks you ordinarily aim ahead of the duck, and if you are hunting, if you will excuse the expression, aeroplanes you would ordinarily aim ahead. With the Draper sight, if you found your tracer bullets were ahead of the thing instead of moving this way

COMMISSIONER GIBSON: There will be a net gain as a result?

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During the war I remember there was a very famous Draper gunsight that had the great virtue that if it did not work you threw it overboard. There was one little problem with it. If you were ducks you ordinarily aim ahead of the duck, and if you are hunting, if you will excuse the expression, aeroplanes you would ordinarily aim ahead. With the Draper sight, if you found your tracer bullets were ahead of the thing instead of moving this way

you moved the other way. It was amazing how 18-year old navy men would learn in about half an hour to adjust in that way, just the way a dentist sees everything in a mirror.

COMMISSIONER GIBSON: You are not suggesting this is so?

PROFESSOR SAMUELSON: No, and none of the witnesses before the Radcliffe Committee said that this was so, or even that the velocity would just wipe out the effects. However, in that deep depression liquidity trap situation that doctrine would almost literally be correct, that velocity changes would just exactly wipe out the increase in M.

COMMISSIONER GIBSON: But in a boom era, supposing the velocity change wiped out say two-thirds of the change in quantity -- well, it is not as simple as that. What the central bank does is not allow the money supply to increase and cause a demand rising and the velocity goes up?

PROFESSOR SAMUELSON: Yes.

COMMISSIONER GIBSON: Supposing the velocity factor in the creation of credit outside the banking system works to offset this policy to a major degree, have you any thoughts about policies in this area, where a deliberate measure leads to inflationary activities of certain other financial intermediaries and certain other kinds of transactions?

PROFESSOR SAMUELSON: I have no definite recommendations,to make, but my general economic

[illegible]

[illegible] adjust in that way, just the way I [illegible] everything in a mirror.

COMMISSIONER O[illegible]: You are not [illegible] this is so.

PROFESSOR SAMUELSON: No, [illegible] witnesses before the [illegible] committee [illegible] this was so, or [illegible] wipe out the effects. However, in [illegible] literally [illegible] would [illegible] literally [illegible] changes would just exactly wipe out the [illegible] of it.

COMMISSIONER O[illegible]: [illegible] era, concerning the velocity [illegible] two-thirds of the [illegible] -- well, [illegible] not as simple as that. What [illegible] is not so, the money supply [illegible] a general rising [illegible]

PROFESSOR SAMUELSON: Yes.

COMMISSIONER [illegible] velocity factor [illegible] the banking system [illegible] a major degree, have you any [illegible] in this area, where a deliberate [illegible] inflationary activities of certain other [illegible] intermediaries and certain other kinds of transactions?

PROFESSOR SAMUELSON: I have no [illegible] but as general economic

diagnosis would be that you do not want to have what we have in the United States: non-member banks who are free from the reserve regulations of member banks and who, therefore, come into their own as sort of ersatz banks when the Federal Reserve is putting pressure on the member banks. In principle you ought to impose the same regulations on all banks. I do not think it quite follows from this that other insurance companies should be subjected to the same degree of scrutiny, that is proper for commercial banks. I am sure that in our country the mutual savings banks and public lending associations provide many, many of the functions of money, and it would be I think in the public interest not to require the central bank to operate terribly hard on that narrow area where it can impinge directly to achieve the same effects, because it is a distortion to do it that way. It is better probably to be able to put on pressure a little more widely.

COMMISSIONER GIBSON: You think it is a big enough distortion to take seriously, in other words? We have had suggestions by some witnesses from your country that it is a distortion but not terribly important and, therefore, for the time being probably nothing should be done about it.

PROFESSOR SAMUELSON: I do not think that I am in a position to make a concrete recommendation in respect of the position of the central banks and just what the control ought to be over finance intermediaries. I do think in time, for example,

eliminate would be that you do not want to have what we have in the United States: non-member banks who are free from the reserve regulations of member banks and who, therefore, come into their own as a sort of credit leader when the Federal Reserve is putting pressure on the market [illegible]. In principle you ought to impose the same regulations on all banks. I [illegible] think it quite follows from this that other [illegible] companies should be subjected to the same [illegible] of [illegible]. [illegible] I am sure that in our country the [illegible] and public lending [illegible] of the [illegible], and it would be I think in the public interest and to [illegible] to [illegible] [illegible] effective, because it is a [illegible] way. It is [illegible] pressure a little more widely.

CONGRESSMAN [illegible]: [illegible] big enough direction to [illegible] worried? We have had [illegible] by [illegible] from every country that [illegible] certainly important and, therefore, [illegible] being properly [illegible] should be done about it.

PROFESSOR SAYERS: I am not sure that I am in a position to make a concrete recommendation in respect of the position of the central banks [illegible] just what the control ought to be over these institutions. [illegible]

that if your country here ever resorts to directives, in which directive the commercial banks are told to do such and such with respect to your lending policies, that at such a time a directive ought to be given to insurance companies. It needn't be the same directive, but I do not see why one should be let off Scott free while the other has a great deal of tightness on it. I believe that by enough tightness on commercial banks you can put a great deal of tightness in the system. It is a little bit like a tourniquet around the neck; in order to get that over-all tightness it is a little hard on the neck, or the commercial bank.

COMMISSIONER GIBSON: In other words you think in terms of what is sometimes described as moral suasion in this outer area?

PROFESSOR SAMUELSON: Excuse me. When I said a "directive" I didn't mean what we laughingly call "moral suasion" which involves not even a slap on the wrist. I was thinking of the kind of directive that the Chancellor gives in the United Kingdom which has force in it. Dr. Holtrop I believe testified before you about the directives that the Dutch government gives to the central bank.

COMMISSIONER GIBSON: Yes, but he said the central bank had powers to do things in this area by legislation and they did not usually do it, they made suggestions instead.

PROFESSOR SAMUELSON: Yes.

COMMISSIONER GIBSON: As I understand it in the States the powers to do these things for the most part are not in legislation?

PROFESSOR SAMUELSON: I think that is true.

COMMISSIONER GIBSON: Is that not right?

PROFESSOR SAMUELSON: That is right. We do not have four big banks or six big banks which are chained across the country, we have fifteen thousand banks. While J. P.Morgan in his heyday could crawl into his panelled library, the principal bankers in New York could do things which were regarded as in the public interest in a crisis, but it does not help for the Chairman of the Federal Reserve Board of Governors to say that the banks in Berlin, Wisconsin, or in Columbia, Missouri, ought to be tightened up. Mr. Sproul's testimony was that in his experience this is generally rather ineffective. I think therefore it is a little bit unfair or immoral to attempt it because it makes those who are extremely co-operative and law-abiding -- I should not say "law-abiding", but public-spirited -- take it on the chin as against the others, and you should not do that because in an emergency, and particularly in a country of this type, the kind of animal with which we are concerned is a very moral animal, and moral suasion is an effective thing in respect to the bulk of cases.

COMMISSIONER GIBSON: Would you agree that the most important factor in producing this contrary

[illegible]: As I understand it in the United States all these things for the most part are not in legislation?

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COMMISSIONER GIBSON: Is that not right?

[illegible]: That is right. We do not have four big banks or six big banks which are operating across the country. We have 14,000 thousand banks. While J. P. Morgan in his heyday could crowd into his private library the principal bankers in New York would be [illegible] were regarded as in the public interest in a crisis, but it does not help for the Chairman of the Federal Reserve Board of Governors to say that the banks in [illegible], Wisconsin, or in Memphis, Missouri, ought to be tightened up. Mr. Snyder's testimony was that in his experience that is generally rather ineffective. I think there [illegible] it is a little bit unfair [illegible] because it [illegible] mere [illegible] are extremely conservative and law-abiding -- I would not say "law-abiding", but public-spirited -- take it on the chin [illegible] the others, and you should not do that because in an emergency, and particularly in a country of this type, the kind of animal with which we are concerned is a very moral animal, and moral suasion is an effective thing in respect to the bulk of cases.

COMMISSIONER GIBSON: Would you agree that

action in the area of velocity is the outside institutions, particularly in times of high interest rates which multiply and intensify ---

PROFESSOR SAMUELSON: Yes, high interest rates, and in time of stringency, the near money substitutes are meeting extremely accommodating holders. In other words, it is very near money in those circumstances.

To illustrate this point, you can get in the City of Boston at the moment 3 per cent on your savings account on a daily basis, per day. That means that anyone with any means will have a much smaller chequing account which he holds in between the purchases of different kinds of securities. The bank is very accommodating and will not get angry at you if you begin to use your savings account as if it were your chequing account. Whereas when money is easy, they really do not want customers. They will say to you, "Look here, if you are going to make this sort of entry every day, and every time you want to buy a dozen eggs you go and use your savings account, then we will not give you a per day treatment". This is associated with the effective rise in interest rates and with the velocity increases. It is not hard to increase velocity because very few of us are at the minimal level of cash balances where our velocity is maximum.

In a time of great inflation where we rush from the factory to, I will not say the saloon, but to the grocery store, to spend the money before its

[illegible] in the area of [illegible] is the [illegible]

horticulture, particularly in times of high interest

rates which multiply the loss ---

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

they will say to you, "Look here, if you are going

to make this part of [illegible]

[illegible]

[illegible] you will [illegible]

any [illegible]. This is [illegible]

alternative [illegible] in [illegible] pieces [illegible] will [illegible]

velocity increased. [illegible]

velocity increases [illegible] the original

level of [illegible] velocity is [illegible].

In a [illegible] in [illegible] where we [illegible]

from the [illegible], I will not say the subject, that

is the [illegible], to spend the money before [illegible]

purchasing power melts, we then get down to rock bottom velocity. But most of us can afford the luxury of a cash balance.

May I now bring up a matter which I meant to put in my submission, although I do not know how relevant it is to the Canadian system. We have a peculiar law in my country that a chequing account cannot pay interest. That law is a vestige from the great depression, and it is there for two reasons. One is a feeling that there is something wrong about interest on chequing accounts, and that the debâcle of the great depression and certain over-banking was related to it.

I think this is a matter of incorrect identification, but there is certainly a cartel reason for it. In its heyday, American business was encouraged to be very cartel-minded, and it is quite natural, under those circumstances particularly, with the branch banking system in a lot of small banks, that the bankers would like to have it legislated that they are not allowed to pay interest, or, rather, their rivals are not allowed to pay interest, on demand deposits. We are still saddled with that law. Now banks try to get round that law in various ways, such as being very accommodating in taking care of your trading stamps, and doing all sorts of things for you, but only when short-term money rates are not at the floor. If we ever get into an epoch in 15 or 20 years where short-term money rates average round 4 per cent,

the demand deposits which are not allowed to bear interest will shrink in volume down to a minimal level.

It is for this reason that I bitterly regret that the Commission on Money and Credit in the United States made a recommendation of the contrary policy, because most of what is money in the important sense will turn out to be interest-bearing deposits. The whole purpose of reserves is not to be punitive but to have control over the money supply, and the effective money supply will be interest-bearing accounts.

I discovered in my travels in various countries that it is a rarity abroad for people to hold any kind of demand or chequable deposits which pay no interest. In Boston in 1922, say, you could get 6 per cent on your chequing deposits. Or, what is the same thing, during the 20's in the United States, in my experience people could cheque against their savings deposits. Now, I do not like speaking of natural tendencies, but there is a natural tendency for money to bear interest if there is a good safe interest rate, and so what many people speak of as near money will practically be the money.

If I were setting up a constitution for a new banking system, and if I were to watch out for all ceilings I would be against ceilings that permitted term deposits, and would prohibit them from paying more than a certain amount of interest.

[illegible]

[illegible] will shrink [illegible]

[illegible]).

It is for this reason that I strongly urge that the Commission on Money and Credit in the United States make a recommendation on the currency policy, because most of what [illegible] in the important sense will turn out to be interest-bearing deposits. The whole purpose of reserves is not to be punitive but to have control over the money supply, and the effective money supply will be interest-bearing accounts.

[illegible] discovered in my travels in [illegible] countries that it is a rarity [illegible] people [illegible] any kind of demand or checking deposits which pay no interest. In [illegible] you could get [illegible] per cent on your checking accounts. [illegible] is the same thing, [illegible] the United States. In my experience people would [illegible] their [illegible] deposits. Now, I do not [illegible] natural tendencies, but there is a natural tendency for money to bear interest if there is a good rate interest rate, and so what [illegible] people speak of as near money will [illegible] be true money.

If I were setting up a constitution for a new banking system, and if I were to watch out for all ceilings I would be against ceilings that permitted term deposits, and would prohibit them from paying more than a certain amount of interest.

They are all right when they are irrelevant; when they are relevant they are bad. I would be against ceilings and floors on loan rates too.

COMMISSIONER GIBSON: You would have no ceiling rate at all on current account deposits? In other words, banks would prefer you to pay interest as they saw fit?

PROFESSOR SAMUELSON: I think as compared with our present system in the United States, I would prefer that. At the very least I should like the Federal Reserve to have wider statutory limits than it now has. I think now it is three or four per cent -- it has just been changed by law a couple of days ago -- for international accounts. I should like the Federal Reserve to be able to put a ceiling of 6 per cent on banks if the money market rose to very high levels.

Now, whether we should get rid of all ceilings or not is perhaps a more drastic step. I think I would rather have the Federal Reserve have the right to impose ceilings as it sees fit, but in the confident expectation that the Federal Reserve would not use those conditions in a repressive way, except under very great emergency and for specific reasons; but particularly not for the reason of keeping bank earnings up.

COMMISSIONER LEMAN: For this reason -- that is, the effect on higher interest rates of change in the character of the real money supply, and so on -- and for certain other reasons,

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COMMISSIONER [illegible]

that is, the effect on higher interest rates of change in the character of the real money supply, [illegible]

Dr. Bernstein expressed the hope, and to some degree the opinion, before us that perhaps you could work within narrow ranges of interest rates, and that interest rates would not have to go quite so high or quite so low in the future. In other words, if you worked between 3 per cent and 5 per cent instead of 2 per cent and 6 per cent, or 2 per cent and 7 per cent, it would be a much happier and more effective monetary system. Do you think that that is a practicable idea? It appeals as desirable if one could do it.

PROFESSOR SAMUELSON: I am not sure that I understand his position. Is it his opinion that if you made certain changes in institutions, you would be able to do that? Or, is it his opinion that conditions of modern life ahead are probably the sort that you would find you would be able to do that?

COMMISSIONER LEMAN: Yes, that is it.

PROFESSOR SAMUELSON: On the whole, I have been of the opposite opinion, namely that the people around 1950 in our country who advocated free money markets should have realized what the consequences of them would be, namely that free money markets fluctuate a great deal. For example, the price of cocoa will go from a ten-fold price in a really free market to one-tenth. The price of natural rubber in a truly free market will oscillate a great deal. I have thought that with changing fortunes of different countries, and changing degrees

Dr. Bernstein expressed the hope, and I also hope [illegible] [illegible] within narrow ranges of interest rates, and that interest rates would not have to go quite so high or quite so low in the future. In other words, if [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]

PROFESSOR [illegible]: [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]

[illegible]: Yes, that is it.

PROFESSOR [illegible]: On the whole, I have been of the opposite opinion, namely that the [illegible] free money markets should have realized what the consequences of them would be, namely that free money markets fluctuate a great deal. For example, the price of money will go from a terrific price in a really free market to one-tenth. The price of [illegible] market in a truly free market will fluctuate a great deal. I have thought that with [illegible] [illegible]

of investment opportunities over decades, a flexible monetary policy, if it is doing what it should, would probably involve us in a considerable range of interest rate changes. But I did not regard them as disastrous.

COMMISSIONER LEMAN: Not on a narrow range, anyway?

PROFESSOR SAMUELSON: No. But I do not speak with any conviction on this because I have not thought recently about it.

COMMISSIONER LEMAN: Mr. Gibson, was not Dr. Bernstein basing his argument on a mathematical basis? Did he not say that he thought 90 per cent of the desired result came from that narrow range?

COMMISSIONER GIBSON: Yes, that is correct.

COMMISSIONER LEMAN: That you were just chasing the last 10 per cent of these wider swings.

PROFESSOR SAMUELSON: I agree with that interpretation. I believe that in this regard primarily, and perhaps only, when we economists henpeck the Federal Reserve, one of the places where they are most vulnerable is that they do over-do things. Although there are no announcements to this effect, they slipped into the habit of thinking that they could spit against the wind and not take anticipatory action. A little like the old Dow theory of equity price forecasting, you did not try to anticipate the turn, but you tried to recognize the turn not too long after it occurred.

I think that was generally their philosophy because of some disillusionment with economic forecasting, including certain errors in my profession made right after the war that ought not to be glossed over. I think this worked badly in the United States in the post-war period because we have had a number of interesting business - cycle patterns.

Our upper turning points, when we go from a rise to a fall, have not been sharp peaks. They have been long, meandering tops. An example of that would be from June of 1956, roughly, until the middle of 1957. The economy was not falling, but it was scarcely rising at all. The same thing happened in the first part of 1960. We now date the turning point at May, but from January on the system was really levelling off. I almost think that I detect in the present situation of the American economy that sort of thing.

Now, in the past, fortunately not this time -- I hope not this time -- the Federal Reserve has just kept tightening even through that period, though most businessmen felt that the bloom was off the boom. I take it that that was an error in judgment. Well, it was an error in judgment. In other words, using hindsight, as they had to do in the stream of history, it was not obvious to them or to me at the time as it now appears to be obvious. But even at the time I would have felt, I think, that there was an error in judgment. If that is what Dr. Bernstein means, that that last pound of

I think that [illegible] generally [illegible] in some [illegible] including [illegible] after the war that ought not to be glossed over. I think this worked badly in the United States in the post-war period because we had [illegible] of [illegible] business - [illegible].

The [illegible] policies, when we go from a [illegible], have not been [illegible]. They have been, sometimes, [illegible]. An example of that would be the [illegible] of 19[illegible], [illegible] the middle of 19[illegible]. The economy was not [illegible], but it was [illegible] at all. The same thing happened in the first part of [illegible]. We [illegible] period of May, but [illegible] was [illegible], etc. I [illegible] that I [illegible] in the [illegible] of the [illegible] economy that sort of thing.

Now, in the [illegible], [illegible] that this time -- I hope not this time -- the Federal Reserve was [illegible] even [illegible] that period, though most businessmen felt that the bloom was off the boom. I take it that was an error in judgment. Well, it was an error in judgment. In other words, using hindsight, as they had to do in the process of discovery, it was not obvious to them or to me at the time as it now appears to be obvious. But even at the time I would have felt, I think, that there was an error in judgment. If that is what Dr. Bernstein means, that that last pound of

flesh which the Federal Reserve has tended to take out of the market has been a mistake, I agree. But his is probably a two-sided accusation, namely that you should also not flood the market as we did in the earlier recessions, where the bill rate got down to about one-half of one per cent. I think it is interesting to compare what happened in the 1960-61 recession and in the rather weak 1961-62 recovery with the bill rate. It was never permitted to go down below 2 per cent. You could not see from any announcement of the Federal Reserve that its policy was to keep it going down below 2 per cent, but it now looks as if it was a visible hand which kept it from going below. I think that is quite understandable, but understandable only for one reason, namely the international balance of payments situation. It is not that it would have been a bad thing, in my judgment, if it had gone lower from the purely domestic viewpoint, but given our balance of payments problem and the competitive rate in London, and so forth -- and this is a consideration which for Canada will always be, probably, more important than for the United States, because you have a smaller and more open economy -- then it was a wrong thing.

I do not think it was a wrong thing for one of the reasons which Chairman Martin gave in recent legislative hearings, namely that it is a bad thing to flood the market -- that a sloppy market is something which does nobody any good and which ought

[illegible]

[illegible] important [illegible] for the United States, because [illegible] a wrong thing.

I do not think it was a wrong thing that one of the [illegible] [illegible] -- that a sloppy market is [illegible]

to be avoided. I have commented at some length in my submission on that point. In particular, if you are not confident that the recession is a short one and that it is in the social interest to deepen capital and to move down the diminishing returns schedule of rate of return to capital, what you have to do is to break through conventional notions. That is why monetary policy was so ineffective in the 1930's. People may believe that the long-term rate for the 1930's was as much below the 1920's as in retrospect it should have been. This flooding of the market resulted in excess reserves for the commercial banks, which resulted in bill rates which got down to three-eighths of one per cent. No, three-eighths of three-eighths of one per cent. There was a time when you had 37 cents on $1 million. And there were also times when there were negative rates. That is hard to understand except that there were certain bidding privileges. It was in such a way that I was told that a $1 million 90-day bill would expire and would not be brought to the treasury for payment. I asked how that was, and the answer was: "Do you know a better way to hold a million dollars than in a treasury bill?"

Such rates, of course, were not themselves accomplishing anything, but if you look at the Treasury Curve relating interest rates and bond maturities, you would find that it was slowly shifting down all during the 1930's. There was nothing at all wrong in this but the astute bankers

[illegible]

to be realized. I have commented on some things in [illegible] in Washington, if you ask [illegible] that the [illegible] is a [illegible] and then it is [illegible] capital and to prove down the diminishing returns schedule of rates of return to capital, when you have to do it by brute [illegible] conventional methods. That is why monetary policy was so ineffective in the 1930's; people may well [illegible] that the long-term rate for the 1930's was [illegible] points below the [illegible] it should have been. This freezing of the market resulted in excess demand for the [illegible] bonds, which resulted in [illegible] to three-eighths of one per cent. No, three-eighths of [illegible] of one per cent. These were [illegible] when you had [illegible] cents on $1 million. And there were [illegible] times when there were negative rates. They [illegible] would have been [illegible]. I was in [illegible] $1 million [illegible] would [illegible] the Treasury for [illegible]. I asked how that was, and the answer was "[illegible] way to hold a million dollars [illegible] a Treasury bill."

[illegible] Patman, of course, said [illegible] accomplishing anything, but if you look at the Treasury Bonds yielding interest rates and long maturities, you would find that it was almost [illegible] down [illegible] during the 1930's. There was nothing at all wrong in [illegible] out the [illegible] bankers

were going to the long end because they did not think that rates would harden back to the level of the 1920's as much as the more inert bankers thought. But the inert bankers finally followed the astute bankers, and this gradual process was helped along by the most tremendous gold inflow in recorded history, a tribute mostly to Herr Hitler. Still you could not get long-term rates down very fast. I do not think you could have done it at all with a bill rate held at 2 per cent during that period.

This is an occupational disease with money manipulators. They do not like things to get out of control or to have a sloppy throttle. Then they worry about what would happen if everybody suddenly spent their money and accelerated velocity, and all this affects their sleep. Central bankers are especially prone to that sort of nightmare. That is why they engineered an increase in reserve requirements, practically doubling them in 1936 and 1937. One of the naive arguments made was they were excess reserves and were not needed. Indeed they were above required reserves, but that does not mean that the prudent banker did not want them, and that he would not want to re-instate them in some degree. So we had some monetary tightness, which came as a surprise to some central bankers, and this played its role in our 1936 and 1937 turning point.

In principle, I do not like a sloppy market, but if that is the way in which we bring

[illegible]

[illegible]

[illegible]

pressure on long-term rates at a time when you want to bring pressure on long-term rates, let the central bankers stand it. That is what they are paid for. The world is made not to give them an easy time; their purpose in life is to suffer pain for a good cause. But I do not think it is likely that we will soon meet a great depression with such rates. I believe that Dr. Bernstein is absolutely right that conditions have changed, and that you will not have the same shock in confidence and break in trend. But I do believe that there will be lots of times when you will not want to have a narrow range for the bill rate. If you do have international reasons, then I would hope very much that you would not stick to bills only or bills preferably in policy. I had meant to enlarge on that and mention it in my submission, but I did not have time to do so.

COMMISSIONER GIBSON: Professor Samuelson, you have pretty well answered the questions I asked you. You might want to say a little more about it. We have had presented to us two pretty contrasting points of view, one by Professor Lundberg of Sweden, and the other by certain people from the United States. The view of the one, the one which Professor Lundberg called the Swedish view, was that a willingness to intervene in the process of monetary transfers in a lot of places was either to make it more easy or more difficult, but not to have any sort of fixed rule as to how to do it, and to work over a very wide area. In contrast to that there was the sort of

pressure on long-term rates at a time when that is being exerted on long-term rates, let the central bankers stand it. That is what they are paid for. The world is made not to give them an easy time; their purpose in life is to render pain for a good cause. But I do not think it is wrong that we will soon meet a great depression with more force. I believe that Dr. Bernstein is absolutely right that conditions have changed, and that you will not have the great decline in confidence and trust in Europe. But I am telling that there will be lots of times when you will not want to take a [illegible] steps [illegible] would apply. If you do know [illegible], however, then I would rather very much that you treat any policy as being only of minor importance, in passing. I feel sure its relevance [illegible] and mention it to my colleagues, but I did not have time to do so.

[illegible] CHAIRMAN [illegible]: Professor [illegible] you have really well answered the question I raised [illegible]. You might want to say a little more about it. We have had proposals, during the [illegible], reflecting points of view, one by Professor Lundberg of Sweden, and the other by [illegible] from the United States. The view of the one, that was what Professor Lundberg called the Swedish view, was that a willingness to intervene in the process of monetary limitation is a [illegible] to make it more ready [illegible] more difficult, but not to have any sort of fixed rule as to how to do it, and to work over a very wide range. In contrast to that there was the sort of

bills only or bills preferably approach of the United States, with its philosophy of non-intervention elsewhere. I take it from what you say that you are at least somewhere between these two approaches. You have expressed the feeling that an unconventional approach on the part of the central bank would be desirable, and you have given us a number of illustrations.

PROFESSOR SAMUELSON: I would say that in principle I am closer to Professor Lundberg. I am especially closer to Professor Lundberg in terms of drafting permissive legislation.

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PROFESSOR SAMUELSON: I would say that in principle I am closer to Professor Lindberg. I am especially closer to Professor Lindberg in terms of drafting permissive legislation.

I would hope that in most years and in most times that most of the operations of the central bank would be conventional ones, and for purely technical reasons I think it is understood that most operations all the time will be in short-term bills. I would even go beyond that and say that many times there would be no particular reason against doing almost all your operations in bills. However, there are lots of times when I think that would do harm, and it should not be regarded as a violation of characteristic central banking practice or of sentimental human freedom to depart from that.

There is not a long tradition in our country of bills only. We always have to forge traditions in our country and to do so on a fast basis. Prior to 1952 there was no such tradition. Then a Select Sub-committee meeting in private and unknown to and independent of most academic economists, came out with the notion that true central banking traditions required operations in bills only.—Until that announced effect came, most of the world did not know about it. I do not think it is true.

The Federal Reserve has recently departed from that practice. I should not exaggerate before you the benefits that came in terms of the Treasury structure from this; but the effects, such as they were, were in the right direction.

COMMISSIONER GIBSON: Professor Samuelson, would you care to say a word about the opposition that has been expressed with respect to broader market

operation policies and the claim that you do not get as smooth marketing operations as you otherwise would.

PROFESSOR SAMUELSON: I do not agree that such operations are distorting. You get certain breaks in the sort of smoothness you want to have; but I do not think one can start out with the axiom that it is correct to intervene at the shortest end and let the market adjust itself, or that it follows from this that (1) you will get the most efficient market and (2) any departure from it is a philosophically indefensible infringement of freedom. We have crossed the Rubicon and know that money will not manage itself and that the nation has an interest in a stock asset policy. But this has effects and I do not want to advocate indiscriminate interference with the long-term markets. An example would be the present time when there is a genuine conflict between domestic purposes and the international balance of payments. If we were a small country and had a floating exchange rate the sharpness of that dilemma would be reduced.

In brief, if I understand most of the spokesmen of the Federal Reserve who advocate the position that I am criticizing, they do not go so far as to say it should not be done, but they say it should not be done by the central bank. The debt management is a legitimate function of the Treasury and there should be a certain clearing of the maturity structure by the Treasury, but this should not be done

corrective policies and the blame that you do not get as [illegible] [illegible] [illegible] [illegible] [illegible].

PROFESSOR SAMUELSON: I do not agree that [illegible] [illegible] [illegible]. You are [illegible] [illegible] in the sort of [illegible] you want to make; but I do not think one can start out with the axiom that it is correct to intervene at the shortest end and let the market adjust itself, or that it follows from this that (1) you will get the most efficient market and (2) any departure from it is a [illegible] [illegible] [illegible] of [illegible]. We have [illegible] the [illegible], and [illegible] that [illegible] will [illegible] [illegible] [illegible] that the [illegible] has [illegible] [illegible] in a [illegible] [illegible] [illegible]. But this has [illegible] and I do not want to [illegible] [illegible] [illegible] [illegible] with the long-term [illegible]. An example would be the present time when there is a genuine conflict between domestic [illegible] and the international balance of payments. If we were a small country and had a floating exchange rate the [illegible] of that dilemma would be [illegible].

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within the tent of the central bank.

Since I am not enamoured of the analogy of two people tugging at the steering wheel, I think this is a part of the asset policy which could be done in either tent or both, and in our case I would say both. I think the Federal Reserve is in a much better position to give us the kind of debt structure we want than is the Treasury alone. We should have a differential maturity policy of the debt in order to help stabilize business activity. It is not a strong nudge, but it is a nudge in the right direction. I find it amusing that the barefoot Populists in Congress should oppose central banking and think the best interest rate is a low one for debt management and other reasons. They are almost identically in the same analytical position as are the purists for bills only. They both pooh-pooh the differential effects on aggregate demand that would come from having a varying maturity of debt structure.

They say you cannot offset the interest rate differential anyway, that the market is just going to snap back to its original place.

I am very happy to be in on either camp on that position. I will even go further in support of unconventional credit policies which I think in certain circumstances ought to be followed. I admit it is disputable whether the central bank ought to do them or whether you should have the central bank not do them, and then have Ersatz central banks do them. What I do not want to have is this: If the central

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[illegible] of two people together at the steering wheel, I think there is a part of the asset policy which could be done in either bank or both, and in our case I would say that. I think the Federal Reserve is in a much better position to give us the kind of debt management we want than is the Treasury alone. We should have a differential maturity policy of the bank in order to help stabilize our money markets. It is not a [illegible] number, but it is a nudge in the right direction. I find it amusing that the Canadian [illegible] to [illegible] central banking and the [illegible] a few and few [illegible] and other [illegible]. They are [illegible] in the same [illegible] the [illegible] effects on aggregate demand that would come from having a changing maturity of debt [illegible].

They say you cannot offset the interest rate differential entirely, that the market is still going to snap back to its original place.

I am very loath to [illegible] on either side on that position. I will even go further in support of unconventional credit policies which I think [illegible] is immaterial whether the central bank ought to do them or whether you should have the central bank not do them, and then have Ersatz central banks do them. What I do not want to have is this: If the central

bank is not to do it, I do not want it to be in a position to negate and inhibit the ersatz central banks that the populace in its considered judgment sets up to accomplish these aims. I think we need the privileges of money and credit creation to back up these unconventional acts.

COMMISSIONER GIBSON: Do you think as a practical matter that debt management can be used significantly in an anti-cyclical way?

PROFESSOR SAMUELSON: Yes, if you are willing to pay the price; and the price you have to pay is that such a step will have a significant effects upon the interest rate structure. Another price you have to pay is that it changes the amount of debt service charges. I never have thought that the duty of a Secretary-Treasurer or of a chancellor is to float debt at the lowest possible rate and cater to his vanity and have new issues that go over the top. A new issue that goes off the starting line too fast has been improperly priced. Nor is it the job of the Secretary-Treasurer to desist from spending money. It is his duty to spend money in good causes and to desist from spending money in bad causes.

Part of the price we pay for a differential asset structure yield curve is that the debt service charges, which are about $10 billion in the present American budget, will be enlarged by this fact. I would not pay a cent too much for debt service without getting the quid pro quo, but I would pay

in this form for benefits of stabilization.

COMMISSIONER GIBSON: But it is sort of a conservative pattern of debt management from the standpoint of the treasury to borrow money as economically as one can and to have a series of maturities that do not expose you to too much, in any given year, of an embarrassing situation?

PROFESSOR SAMUELSON: I do not think that the last point you made about staggering your maturities in a convenient way is a conservative position thattought to be criticized.

COMMISSIONER GIBSON: No. That is what I am getting at.

PROFESSOR SAMUELSON: That is a perfectly sensible device, but I think it is wrong to believe that the purpose of the Secretary-Treasurer is to be able to have long periods of time when he does not come to the market at all. It is the purpose of any bank to be prepared to pay out money all the time to its depositors, and it does it. It is the purpose of any modern chancellor of any modern treasury to be always turning over the debt, a large part of the debt, even if you think there should be some long debt; and in doing this, no one should be regarded as doing anything extra and deserving time and a half pay. That is just part of his job. Nor should one wonder what would happen if the market would not take the short-term debt; we all live by promises we make to each other. There is no day of liquidation and there will not be a time when

everybody will refuse short-term debt. I myself see absolutely no reason why the central bank should not be permitted to buy debt directly from the Treasury.

COMMISSIONER GIBSON: But you do not see any conflict from the Treasury's point of view in trying to get debt management to gear a little more to an anti-cyclical position?

PROFESSOR SAMUELSON: No. I do recognize that just as there are historical patterns in the personality of central bankers there are historical patterns with respect to chancellors and secretary-treasurers; and there has been a tendency for them in many past epochs to be much too worried about service charge reduction, in the belief that they have been clever fellows if they were able to float the debt at 2 per cent instead of 2½ per cent. I say they are clever when they float it at 4 per cent when it should, for stabilization reasons, be floated at 4 per cent. They are also clever fellows if they adjust the maturity patterns to suit insurance companies and anybody else in the market, just as anybody who has a product which accommodates his customers' needs is able to make or save a little money by that device.

COMMISSIONER GIBSON: Thank you very much. I think I have asked Professor Samuelson enough questions for the moment, sir.

THE CHAIRMAN: Are there any other questions on this subject?

COMMISSIONER BROWN: I should like to pursue this question of the control of non-member banks. You showed very clearly that as the number and variety of these banks increase, the leverage factor with respect to the control of the central bank decreases. You say you are in favour of having more direct controls available to the monetary authorities. What sort of controls were you thinking of?

PROFESSOR SAMUELSON: If I could write my own ticket for my own constitution I would want uniform rates supplied to non-member banks of the Federal Reserve System. Of our 14,000-odd banks I think probably four or five thousand are members of the Federal Reserve System and the bulk are not, but I guess they are much smaller, commercial banks and in terms of total value it is probable that we control most of this. But there is still some leakage. There has even been some discussion about big banks getting out from under the Federal Reserve. The minute any big bank does do it, the Federal Reserve will close the opening to them. It is a freedom they have as long as they do not use it, but if you get three big wholesale New York banks and one in Chicago not being members of the Federal Reserve, as some people have begun to suggest, then I think this minor problem would become a major problem and we would move in. I think comparable reserve rates should be specified for mutual savings banks, for workmen's co-operative institutions,

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for federal chartered savings and loan associations, wherever they are not already comparable to reserve rates for time deposits of commercial banks. In that sense these near moneys are going to be controlled. I also think there are times when you would want to raise the reserve rate; at the present time for commercial banks, a savings deposit or time deposit in a commercial bank has a required reserve rate of 5 per cent. That is as against more than 12 per cent on demand deposits.

We have been having a substantial shift into time deposits. In a way this is fortunate because the ordinary kind of deposits have been languishing, and under our monetary policy we would be in real trouble if this were not compensated for. But, suppose the ordinary demand deposits had been growing at an ordinarily satisfactory rate, and you begin to get this movement into time deposits so that the total was growing at the rate of 7 per cent a year and the economy really needed a growth of only 4 per cent? In such a case I would like to see this 5 per cent rate on required deposits increased to 7 per cent.

No banking trade association would ever agree with me, and in no testimony before Congress by the banking community, or in their submissions, would there be agreement because to the individual banker it looks as though it is a wasteful asset. They would say: "You are requiring us, in a punitive way, to hold a non-interest bearing asset." The bankers want to hold only earning assets. To an individual banker a capital savings bank competing with a commercial bank is a horrible thing, and that is why you cannot let bankers run the central banks. You cannot let bankers' testimony dominate the testimony before a commission of this sort. You cannot have on a commission of this sort the good, reliable bankers. If you do, you put them in an uncomfortable position because they are traitors to their class if they say some of the things that have

to be said, although a very respected banker who has made his career and who is above it all could be one of many representatives on a commission like this.

I speak with some feeling on this because we have just had a report to the Controller of the Currency by representatives of the national banks, and I am sorry to say that their recommendations were only too predictable. There are not many of them, you will find, who will run against the near term interests of the national bank as seen by a national banker, and you cannot criticize them for that.

I am not clear in my own mind as to what I would do about financial intermediaries such as finance companies, life insurance concerns, and so forth. It could be the business of a special commission in my country, if Congress and the Executive thought there should be some control over financial intermediaries, to devise a set of controls that could be put on at any time. It is a difficult thing, and I am not prepared to make recommendations.

COMMISSIONER BROWN: Have you any thoughts about direct controls on their operations?

PROFESSOR SAMUELSON: When I speak of direct controls by central banks in this submission I am referring almost always to direct, even-handed controls as against the other medium of direct controls such as fiats. The only one I recognize

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

as a fiat of the conventional central bank is the ability of the Federal Reserve to change the required reserve ratios. That is a fiat, although it is applied even-handedly among different banks, and it has been used in recent years in lowering reserve requirements for structural reasons, and otherwise.

I agree with the position of Alan Sproul in his testimony before you when he said really direct controls have short-run potency, and should be used sparingly for emergencies. We have had three such in our recent history -- control over stock margin borrowing; control over consumer credit; and control over house mortgage terms.

I think the effects of mortgage rate payment controls are very strong in the short run. In the longer run people begin to find lots of different ways of getting around these controls. I do not mean evasion, but I mean that they take avoidance procedures which are not necessarily illegal.

I think that these are potentially tools of social policy, but most Federal Reserve people do not. However, I do think you could save them for emergencies, and the same thing could be said about wage controls and price controls. It is very understandable that we should have resort to such measures on some occasions. They work well in the short-run, and, therefore, I would not want to dissipate them when there are not emergency conditions because they can be used up too easily.

My general inclination is that such controls could be useful when you have to deal with insurance companies. In principle, being able at the right time to control what they do about certain parts of their lending, sounds like a good added implement in the arsenal of general credit control. But I think they should be used very sparingly, and I would not know how to draft the legislation for that purpose.

COMMISSIONER MACKINTOSH: Suppose you have established reserve requirements in the range of these near banks. Would you then expect an open market policy to operate sufficiently on them, or would you, in their case, depend more on changing reserve ratios as a method of controlling them?

PROFESSOR SAMUELSON: I think that open market operations primarily would affect them, so we would just have widened the potency of the open market operations. I am not clear in my own mind as to how quickly the reserve ratios I would use for the commercial banks, or for these near banks, would operate, so I am not able to give you an answer.

COMMISSIONER MACKINTOSH: I do not know much about these things, but it would seem to me that big savings banks, and so on, are very vulnerable to open market operations, but if you stretch the spectrum to the credit unions then probably the ripple in the open market operations does not get out to them.

PROFESSOR SAMUELSON: One of the ways the system adjusts itself to the open market contraction, and avoids the desired effect is to move out to these intermediaries. In other words, money begins to move into the near banks.

There is a natural recourse to these as interest rates get higher. There is a tendency for money to go into direct savings deposits. I do not feel I know sufficient to give a response to your question.

COMMISSIONER MACKINTOSH: You would not go into anything like special deposits?

PROFESSOR SAMUELSON: I would at certain times. I would prefer that to more arbitrary methods of credit rationing. I think, for example, the Dutch system which was described to you by Dr. Holtrop sounds better than some of the instructions given by the Chancellor in the United Kingdom in the post-war period to do things that the banks had either not done or things which, when they did do them, they did in an arbitrary way. This would be a more even-handed way of spreading matters.

COMMISSIONER BROWN: May I switch to a slightly different topic. You described monetary policy as controlling stocks, and fiscal policy as controlling flows, and you described in general terms that there had to be a certain relationship between these two. I wonder if you could give us a little more detail on how you think this should

come about in actual operations?

PROFESSOR SAMUELSON: Well, let me approach it by way of a current example. There is a considerable body of opinion in the United States that there ought to be a tax rate reduction. President Kennedy announced a month or so ago -- in August, I think -- that he was not going to ask Congress for a tax rate reduction within the calendar year 1962, but that he did intend to ask for such a rate reduction in 1963.

There is a great deal of support for that position from the unions and the poor people, and there is also considerable support for it from representatives of business. The latter group in particular are often much impressed by the advice given to us by Europeans and also some bankers within our own country that it is all right to have tax rate reductions which will involve an increased deficit in the short-run provided it is financed out of "real savings". This is interpreted to mean "provided it is not sold to the banking system". I think it would be much more germane to say "provided it is not sold to the central banking system". It is a great illusion that if you sell a bond to the banking system that is inflationary.

It is almost the reverse of the truth, except in times when there is a great excess of reserves, that when you are selling to the banking system it uses up its excess reserves which it would

not have used otherwise. During most of the post-war period whenever a bank bought a bond it had to refuse a borrower, and so the way we would try to deflate the over-enthusiasm of the post-war boom was precisely by getting particular banks to buy government bonds. But, if the central bank buys the bonds and creates extra reserves then that is expansionary. So, it is said it is all right to have a deficit provided that it is counter-balanced by a stock set of moves -- this is a move which is expansionary, and it must be counter-balanced by a set of moves that are contractional to some degree. I have not seen any intelligent discussion as to what in the world this is supposed to mean.

COMMISSIONER BROWN: Perhaps we could have such a discussion now.

PROFESSOR SAMUELSON: Well, you do me too much honour, but I will comment on the matter. If it means that we really should not have more expansion for international reasons, and that when the government creates expansion by reducing tax rates, the central bank has to engineer an increase in real savings just big enough to offset that, then I must say I cannot see the purpose of it.

This is a very unpopular policy. The country has grave doubts about it. Why should we add to a deficit and do all of the bad things of life just for the purpose of getting no fruit from it at all?

I take it that not quite that is meant

by the people in Zurich who give us this good advice. Probably what is meant is that if an expansion follows from this the central bank ought to take this into account in its degree of ease or tightness, but that says nothing. The same thing would be true if there had been a private and spontaneous recovery that was stronger than what we now have.

In an accounting sense our Department of Commerce will always register savings equal to investment and they do that even in periods of greatest inflation. In 1947 when we had the greatest peacetime inflation in recent years, which was a left-over from the method of financing the war, there was always a balance between savings and investment. It comes back to the same kind of notion of neutral money -- that the system has a way of behaving in barter terms which is desirable, and that the real job of the central bank is to try to replicate that condition.

That was my point in the illustration of stock being able to flow and inter-act. Leaving out the international situation for the moment, the effect of this primarily would be that we encourage consumption expenditure by private individuals and by the government, and we discourage investment expenditure. This effect comes about because the conscience of the system with respect to the price level is the central banker and he can always impinge on <u>investment</u> interest rates and <u>investment</u> movements to do what he can to wipe out the excesses

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movements to do what he can to wipe out the excesses

of fiscal policy. This results in a bad mix from the standpoint of growth. If you think we have had enough growth and do not want any more then that is a possible position. But, you should not let the procedure taken by the government, which may make one kind of error, and that taken by the central bank, which may make another kind of error, go on in the hope that the two will cancel out. This illustrates the importance of the stock and flow analysis.

I would not agree with one of your eminent central banking witnesses in his analysis of just what was neutral in terms of deficit financing by one method and deficit financing by another method. He listed half a dozen situations and described which of those was neutral in respect to purchasing power. I do not agree, simply as a matter of technical fact. In some of his cases I thought the stock effects were not big enough to wipe out the flow effects.

Let me illustrate that with respect to my own country. It is sometimes thought that if you pay off the debt by a surplus this step is not deflationary on the system because, after all, when you pay off the debt somebody gets the money and he can put it into investments. If there were a certain conservation law as to purchasing power which said that everything circulates at the same rate, and that this money would be incidentally re-invested, then that view

of fiscal policy. This results in a bad mix from the standpoint of growth, [illegible] economic growth and do not want any more than [illegible] a possible position. Now you should not ignore the [illegible] of the government, which may have one kind of effect, and that caused by the central bank, which may have another kind of effect. So [illegible] in the long run the two will cancel out. That illustrates the importance of the mix and fine analysis.

I would not agree with one of your earlier points, treating differences in the analysis of just what was meant [illegible] financing by one method and [illegible] financing by another method. We think that a given stimulation and financing [illegible] of money and savings, [illegible] I do not agree, simply as a matter of [illegible]. The [illegible] of this [illegible] I thought the [illegible] effects were not big enough to warrant the flow effects.

Let me illustrate that with regard to my own concept. It is sometimes thought that if you pay off the debt by a surplus this is not deflationary on the system because, after all, when you pay off the debt somebody gets the money and he can put it into investments. If there were a [illegible] lies [illegible] conclusion [illegible] said that everything circulates at the same rate, and that this money would be [illegible]

would be correct.

But, unless the central bank deliberately used the paying-off of the debt as an occasion for easing money, the budgetary surplus would be a contractional influence. To my mind, flows and stocks are inter-acting at every point in the symphony -- and I hope it is not a discordant symphony.

I am not sure that I have answered your question, but I have used up some time.

THE CHAIRMAN: We will adjourn until 2.00 o'clock.

---Luncheon adjournment.

[illegible]

"[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

I [illegible]

questions, but I have read my notes.

THE PRESIDENT: [illegible]

[illegible].

— [illegible]

--- Upon resuming at 2.20 P.M.

THE CHAIRMAN: Mr. Brown?

COMMISSIONER BROWN: Mr. Chairman, just before lunch we were starting a discussion of fiscal policies, fiscal techniques, and I would like to get Professor Samuelson's views on the relative advantages and disadvantages of fiscal policies aiming at chances in the tax level as against changes in government expenditures. Perhaps you would start on that general topic?

PROFESSOR SAMUELSON: First, I would say that a dollar of government expenditure on goods and services is expansionary, and a dollar of tax rate reduction is expansionary, but there probably is a slightly greater amount of expansion to be expected from a dollar of government expenditure on goods and services than from a dollar of remission of tax revenue.

I emphasize this because if you were simultaneously to increase government expenditure at a given level of national income by $5 billion, and match it completely by a tax rate increase of $5 million, I don't think the total effect would be neutral. There would be a slight expansion from having the budget balanced if it happened at a high level of activity, because at the high level of activity the government is using up resources and keeping it high. Likewise, a reduction of government expenditure on goods and services by

--- then recessing, at 2:00 P.M.

THE CHAIRMAN: Mr. Brown.

CONGRESSMAN PATMAN: Mr. Chairman, just before lunch we were starting a discussion of fiscal policy, fiscal operations, and I would like to get Professor Samuelson's views on the relative advantages and disadvantages of fiscal policies -- shifts of emphasis in the tax level as against changes in government expenditures. I wonder if you would start on that general subject.

PROFESSOR SAMUELSON: Well, I think I would say that a dollar of government expenditure on goods and services is, dollar-for-dollar, and a dollar of tax rate reduction, on expenditure, the items probably is a slightly greater amount of expansion to be expected from a dollar of government expenditure on goods and services than from a dollar of reduction in tax revenue.

I emphasize that because if you were simultaneously to increase government expenditures at a given level of national income by $5 billion, and match it completely by a tax rate increase of $5 billion, I don't think the total effect would be neutral. There would be a slight expansionary force having the budget balanced if it happened to a high level of activity, because at the high level of activity the government is taking up resources and keeping it high. Likewise, a reduction of government expenditures on goods and services by

several billion dollars, if completely matched by a tax reduction would, on the whole, not be neutral. But the difference between them is of course minor as compared to the fact that they both operate in the same direction.

For practical stabilization purposes, some objects of government expenditure, such as long term public works, have the defect that they take a long time to be planned, and a long time to be carried into effect -- there is a delay in land acquisition and so on, but finally you begin to put out money for the use of resources and this builds up in a characteristic pattern as the school or building progresses.

Now, by the time a great deal of money is actually coming onto the market for labour and for materials, a short recession may have been long behind you and this money may be coming onto the market just at a time when you already are in a vigorous expansion and don't need more resources. So there has been a certain amount of disillusionment among economists about placing great reliance upon public works for short term practical stabilization.

I am afraid that monetary policy has somewhat the same defects, particularly if we examine the induced private construction expenditure, say, in the building of a factory or a hotel which comes from expansionary central bank action. First, the central bank eases the reserve position, brings down interest rates and increases the availability

several billion dollars, if completely matched by a tax reduction would, on the whole, not be neutral. But the difference between them is of course minor as compared to the fact that they both operate in the same direction.

For practical stabilization purposes, some objects of government expenditure, such as long-term public works, have the defect that they take a long time to be planned, and a long time to be carried into effect -- there is a delay in land acquisition and so on, and finally you begin to put out money for the use of contractors and this builds up in a cumulative fashion, according to the nature of building progress.

Now, by the time a great deal of money is actually pouring out, the market for labor and for materials, a short while ago may have been low before you and this money may be coming into the market just at a time when you discover you are in a vigorous expansion and really need more restraint. So there has been a general amount of disillusionment among economists about placing great reliance upon public works for short term practical stabilization.

I am afraid that monetary policy has somewhat the same problem, particularly if we examine the various private construction expenditures, e.g., in the building of a factory or a hotel which some firm commences and has been waiting. When the central bank eases the reserve position, brings down interest rates and increases the availability

of credit. Finally, the promoter makes his plans -- and it takes about as long to build a private structure as it does a public structure. But other parts of monetary policy can be more closely geared to the current state of activities.

Now, tax reduction and tax increases in principle should be subject to more flexible starting and stopping than in fact they are. In the United States it takes a long time for Congress to make up its mind about any fundamental change in tax rates, upward or downward, so there is a considerable delay.

It was for this reason that the Commission on Money and Credit made a recommendation which was perhaps the most widely publicized of all their recommendations, even though it wasn't in the field of money or credit directly: namely, that the executive -- the President in our case -- be given the power by Congress to vary tax rates personally at his discretion, within certain ranges for certain limited periods of time and subject to reversal by resolution of Congress and subject to renewal by Congress. I believe that such innovation came into effect in the last British budget. The government was given the power by Parliament to vary purchase taxes within certain limited ranges, depending upon business conditions, and I believe that use is actually made of that provision.

In the case of the United States government, the Commission made a recommendation -- and

of credit. Finally, the premier makes his plans -- and it seems sound as long as he holds a measure [illegible] parts of monetary policy can be more closely geared to the current state of activity.

Now, the reduction and the increase in principle should be related to more flexible planning and timing than in fact they are. In the United States it takes a long time for Congress to make up its mind about any fundamental change in the power, upward or downward, so there is a considerable delay.

It has been the position that the Commission on Money and Credit made a recommendation which was perhaps the most widely publicized of all their recommendations, with respect to change in the field of money or credit policy: namely, that the executive -- the President in our case -- be given the power by Congress to vary tax rates temporarily at his discretion, within certain limits for certain limited periods of time and subject to reversal by resolution of Congress and subject to renewal by Congress. I believe that such legislation came into effect in the last British budget. The government was given the power by Parliament to vary purchase taxes within certain limited ranges, depending upon business conditions, and I believe that use is actually made of that provision.

In the case of the United States government the Commission made a recommendation -- and

a number of economists have made the same recommendation -- and President Kennedy did ask Congress to give him that stand-by power, as it was called, but Congress in its wisdom has not yet seen fit to do so.

It is asking a great deal of legislators, who struggled so long for control over the purse strings against the kings and despots of former days, to give up this privilege the first time they are asked. The House of Representatives doesn't even like to give it up to the Senate; and since we don't have a cabinet system of government, the cleavage between the executive branch and the legislative branch is much stronger than it is in the United Kingdom or, I dare say, in Canada. I am not optimistic that in the near future in the United States this power will be granted.

But such power would increase the potency and timeliness of fiscal policy and a stitch in time often saves two or three in the realm of the economist. It would have been a good thing in my judgment, therefore, in terms of the situation which we now have, if President Kennedy had been granted or given that power when he asked for it.

COMMISSIONER GIBSON: You were talking about the speed which fiscal measures take and you referred to some parts of monetary policy. Are you referring to the existing situation?

PROFESSOR SAMUELSON: Yes.

COMMISSIONER GIBSON: Will you elaborate more on that? When we were talking about it this

morning we didn't get into this question of lags very far.

PROFESSOR SAMUELSON: Well, that part which impinges upon very durably constructed projects which last a long time in their gestation period and in the planning period, I think would be subject to the same defects as in the case of fiscal policy; that part which had to do with, say, the availability of credit -- an example would be in the United Kingdom during the Maudling Chancellorship when there was a release of a block of war savings, was it special deposits, -- would begin to be felt quite quickly and might begin to be felt in connection with short run decisions.

Another example would be if the central bank has any power over hire purchase; that can be changed, and I think the effect would be seen almost in the next month's statistics. This is getting to be a little bit outside the conventional range of central banking policy, but it is a bit of ammunition which I would like to see in the arsenal of the central bank, but not with the expectation that it would be used all the time or even often. That is the kind of power I had in mind.

COMMISSIONER GIBSON: Are you almost suggesting that the vigorous action or sharp change in monetary policy will in part be felt fairly quickly because of the fact of availability having an effect on other markets, but what about the gradual changes; there is quite a lag?

PROFESSOR SAMUELSON: Yes. I mentioned earlier that sometimes you have to keep pushing short-term rates for a long time in order to have them seep through.

I was thinking of a sentence in Lord Cobbald's testimony where he said that in his experience it took about six months to get a change in the climate of expectations of the money market, and perhaps for the policy to become effective. I am sure that no single figure can be specified with any accuracy, but these things do involve a great deal of time.

There is another slight asymmetry between the delays involved in monetary policy and in fiscal policy that has to do with the following matters. A tax reduction or tax rate increase is a dramatic "once and for all" thing; it usually takes time to do something dramatic and "once and for all".

The central bank, as Mr. Sproul mentioned in his submission to you, can probe and retreat. This is not to deny any one little act of a central bank takes time to work, but it does mean that you can superimpose upward and downward impulses and therefore have a rather better timing relationship over the system. It is like the example in one of the submissions before you of the result of a lot of stop and go driving; you put your feet on the pedal and take them off, not because you want to create jerks, but because the load is an on and

[illegible]

earlier that sometimes you have to keep pushing short-term rates for a long time in order to have them [illegible].

I was thinking of a sentence in Lord Goldsmith's testimony where he said that in his [illegible] in the climate of expectations of the money markets, and perhaps for the policy to become effective. I am sure that no single figure can be quantified with any accuracy, but these things do involve a great deal of time.

There is another slight asymmetry between the changes involved in monetary policy and in fiscal policy that has to do with the relative [illegible]. A [illegible] [illegible] [illegible] and [illegible] and for all [illegible] [illegible] and for all".

The [illegible], as Mr. Sproul mentioned in his submission to you, can [illegible] and [illegible]. This is not to [illegible] the [illegible] of a [illegible] bank [illegible] [illegible], but it does mean that you can [illegible] upward and downward [illegible] and therefore have a rather better timing relationship over the system. It is like the example in one of the submissions before you of the result of a lot of stop and go driving; you put your feet on the power and take them off, not because you want to [illegible], but because the load is an on and

off type of thing. I think there are advantages like that in the realm of monetary policy.

Fiscal policy has that, but not in a discretionary way; there is the built-in flexibility of a modern fiscal system of tax setting whereby the minute business begins to drop off, even if Parliament is out of session , an expansionary mechanism goes into effect. The only trouble with built-in flexibility is that although it resists a motion in one direction it cannot be expected to reverse that motion and wipe out all of the motion; discretionary action could be more helpful in that regard.

COMMISSIONER MACKINTOSH: Would you explain that second last sentence a little further; I didn't quite get it.

PROFESSOR SAMUELSON: With respect to automatic stabilization?

COMMISSIONER MACKINTOSH: Yes?

PROFESSOR SAMUELSON: The powerful automatic stabilizer in our system is our heavy reliance on income tax of persons and our heavy reliance upon income tax corporations; the latter is particularly sensitive to changes in business conditions because profits are a residual item with a corporation and they are especially affected by small variations in business conditions.

Now, when you get a drop in business conditions,let us say a drop in the Gross National Product of a billion dollars, there would be a fractional drop in the tax receipts, but every tax

system which I know of only taxes a fraction of the marginal dollar. Now, that fractional change in tax receipts is in the direction which resists the movement, whether it be downward or upward, but it is always a fraction and never enough to reverse a trend and that is what I had in mind.

COMMISSIONER MACKINTOSH: I see.

PROFESSOR SAMUELSON: I want to emphasize, though, that the wisdom of the past has a half life that is quite short. When Adam Smith sat down to write down the four tenets of taxation, (which his editor said would be just four things he happened to think of that morning,) one of his tenets of taxation was that a good tax is a tax with steady revenue year in and year out, no matter what happens to the state of the economy.

Now, we have turned that doctrine upside down in the 20th century and regard a good tax as one with built-in flexibility and which doesn't work independently of anything but which moves with respect to anything. This is a two-edged sword but it is a powerful drag -- albeit a fractional drag -- on the upside and that is why the automatic stabilizers cut down the amplitude of a pre-existing cycle, but can't cut it out completely or reverse it.

COMMISSIONER MACKINTOSH: I notice that you leave out excise and sales taxes; wouldn't they operate much the same?

PROFESSOR SAMUELSON: The purchase tax,

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

which was a discretionary instrument in the British system, is an example of it; that would act very much in the right direction because it is not gradual. If it is across the board and not applied to luxuries, which have a very high income demand, this tax change is perhaps not as stabilizing as a graduated one, but it is stabilizing and it is an important part of the fiscal systems of our country and is perhaps important for other countries.

COMMISSIONER BROWN: If this applied to luxuries it would be even greater?

PROFESSOR SAMUELSON: Yes.

COMMISSIONER BROWN: This morning you distinguished between a transfer type of government expenditure and an expenditure of goods and services.

PROFESSOR SAMUELSON: Yes.

COMMISSIONER BROWN: Would you like to amplify that?

PROFESSOR SAMUELSON: Yes. An example of an expansion of goods and services would be the hiring of an employee of a Royal Commission, or a judge, or a postal clerk, the purchase of a typewriter for the government, or the purchase of a battle-ship; those use up the resources at the very first round.

An example of a transfer expenditure by the government would be the cost of a payment to a widow, independent of any activity which she now does. To her it is disposable income and on the next round she spends it and it shows up in the Gross National Product figures, but on the very first round it is a

transfer. There are some other transfers that are not important in this connection.

When I was replying to your earlier question about the potency of fiscal policy I was careful to compare the potency of taxes and government expenditure on goods and services.

With respect to transfer expenditures by the government, unless they happen to go to particularly spendthrift types, or to low income groups who are particularly rapid in spending their money, or unless the tax happens to come from particularly wealthy people whose expenditures are independent of their income, it is much more of a standoff. Transfer expenditures have about the same dollar for dollar potency -- and this is just an approximation -- as tax receipts.

COMMISSIONER BROWN: Have any of the other Commissioners any further points on this fiscal matter? Otherwise I would like to ask you for your comments on the proper goal of the Council of Economic Advisers in all this picture?

PROFESSOR SAMUELSON: The present Council of Economic Advisers constitutes a staff for the President -- for the executive; it is within the executive office but it is not literally within the White House. The primary allegiance of the Chairman of the Council of Economic Advisers is to the executive. He is not a disinterested scientist who is free to go and give his opinion on every subject, because his remarks wouldn't be interpreted

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to be those of a disinterested scientist, but would be interpreted to be that of the spokesman of the government. He is not directly responsible to Congress, but he testifies before Congress.

I cannot remember a case recently where the chairman of the Council of Economic Advisers has said: "I refuse to answer the question of a Senator from the Joint Economic Committee because I invoke the privilege of executive privacy", but you can imagine such a case.

He is concerned with fiscal policy, he is concerned with monetary policy, and he meets with committees of a formal or informal sort which have various members of the Treasury, including the Secretary of the Treasury as members, and which various members of the Federal Reserve System, such as the Chairman of the Board of Governors, attend. I do not think that one can imagine a good system in which the Chairman of the Council of Economic Advisers would be in a position to tell the Secretary of the Treasury just how he ought to finance his bonds, or tell the head of the central bank exactly how he ought to conduct his open market operations; but I do think it is appropriate for economists within the government, to make their advice available to the President, who indicates his wishes to his own secretary of the treasury and exercises his good influences with the head of that Federal Reserve.

Going by what has been announced in the newspapers, there have been periodic meetings at the White House to which Chairman Martin of the Federal Reserve has been an attendant. In Woodrow Wilson's day I think this could not have taken place. I believe Woodrow Wilson, when the Federal Reserve

Act was first established, went so far as not to invite to his official receptions members of the Federal Reserve Board lest there be any possible thought that the independence of the Federal Reserve was being infringed. He perhaps remembered Adam Smith's dictum, that tradesmen never get together even for the purpose of social pleasure but what they conspire together against the consumer. He did not want to break bread with the Federal Reserve Board.

Those days are gone. If the recommendations of the Commission on Money and Credit were to go into effect, the Chairman of the Board of Governors of the Federal Reserve would serve at the pleasure of the new president. The president would have the right to name him. No one knows what the unwritten tradition of the United States is when the new president comes in. As far as I know nobody knows. It is possible that President Franklin Roosevelt and the Chairman of the Federal Reserve Board knew what the unwritten tradition was. It is possible that Chairman Martin and President Kennedy knew in 1960, but the likes of us do not know. I cannot believe that is a perfectly satisfactory arrangement. A tradition that everybody knows is just as good as a law, but a tradition that is ambiguous and sometimes followed and sometimes not followed seems to me to have all the disadvantages that one can imagine.

Act was first established, much as they may try to impute to him political complexions outside of the Federal Reserve Board lest there be any possible thought that the independence of the Federal Reserve was being infringed. He perhaps remembered Adam Smith's opinion, that tradesmen never get together even for the purpose of social pleasure but what they conspire together against the consumer. He did not want to break bread with the Federal Reserve Board.

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So to my mind the Council of Economic Advisers is just part of the economic staff of the executive. I am not particularly in favour of the grandiose proposals that have been made by several important people in the United States, that there be a grand council -- let me call it an ecumenical economic council -- involving the stocks and flows set up, to co-ordinate these various things.

I believe that the distinguished Elliott Bell, former adviser to candidate Dewey, the Commissioner of Banks for New York State, editor of Business Week, has proposed such a commission.

Just this summer the distinguished Arthur F. Burns, a professor economics and the president of an economic research committee, the chairman of President Eisenhower's Council of Economic Advisers has proposed a kind of super-authority or group to come together for the purpose of discussion. I have thought a good deal about the problem - and I do not think that this would help a great deal. In fact, it might hurt since the division of responsibility is very unclear in such a situation. You could get an awful lot of buck passing in such a situation.

COMMISSIONER LEMAN: Would you argue even more that there should not be such a council which would be deemed not to be government?

PROFESSOR SAMUELSON: I think I would go a little further. I think that an advisory

council to the central bank is useful. I have in mind the board of the New York Federal Reserve Bank; the board of directors of the Boston Federal Reserve Bank. Those are esteemed citizens picked to serve on the board. The Chairman might be the president of my college. He might be the treasurer of a large oil company. This is a very nice relationship to give the central bank an insight into what is happening in the city and what is happening abroad, but these people do not decide open market operations. It would be wrong for them to do so. I think it is very wrong to depend upon committees outside the government to really call the shots on policy. At periodic intervals this is all right to focus public attention.

We have just had a management-labour committee in the hope of finding something better to control cost-push inflation, which involves fiscal policy and monetary policy. It has representatives of business, it has representatives of labour and it has so-called public representatives. I do not want to pre-judge the matter, but it is my general impression that people have not found it to be a terribly important operation. It certainly has not done a lot for the price-wage cost-push part of the problem. Some economists interested in wages think that if that group were more active it would do more harm than good. So, I do not think that the Council of Economic Advisers should be given part of the responsibility for these acts.

[illegible]

[illegible] in the present case [illegible]. I have in mind the people on the New York Federal Reserve Bank, the board of directors of the Federal Reserve Bank. These are outstanding citizens placed to serve on the board. For instance, take the president of my college. He might be the treasurer of a large oil company. This is a very able individual, to give [illegible] time to looking into what is happening in the city and what is happening abroad. But these people do not [illegible]. It would be unfair for them to do so. I think it is very wrong [illegible] the government is really [illegible]. My particular [illegible] to those [illegible].

We have [illegible] questions of [illegible] to [illegible] general [illegible]. It [illegible] representatives of [illegible], of [illegible] of labor and [illegible] public representatives. I do not want to [illegible] the matter, but it is my general [illegible] that [illegible] to be [illegible]. It certainly has [illegible] part of the process. Some economists interested in would think that if that group were more active it would do more harm than good. So, I do not think that the Council of Economic Advisers should be given part of the responsibility for these acts.

I do not want to speak of the London situation, but the submission before you which I read suggested that it is extremely valuable to have exactly the same composition for the Bank of England as is now the case. I feel that England must be a pretty lucky country to be just right now, so that any change from its current position would be a move toward the worse.

I think that the primary responsibility for central banking operations must lie with the central bank with responsibility to the government after a suitable delay period and without having government breathing down the neck of the central bank in its day-to-day operations.

In the case of the United States the issue debated in the past has been about the relationship of the Federal Reserve to the executive. No federal reserve official known to me has ever argued that he did not owe complete and ultimate allegiance to Congress, so there is no independent Federal Reserve in my country as against legislature and the courts and the executive. There is no fourth estate of government, which is the central bank, and I think properly there should not be such. I think there have been times in certain Continental countries where the central bank has in fact been in power, and even has affected cabinet turnovers by its various foreign exchange operations. I think that is an anomaly in a democracy.

COMMISSIONER BROWN: Earlier this morning

you discussed debt management to some degree, and I think you were quite fair in saying that you considered it as part of monetary policy. Would you care to tie this in with the other point you were discussing this morning, and that is the question of liquidity and the extent to which, by varying the maturity spectrum of existing debt, liquidity is changed?

PROFESSOR SAMUELSON: I think the distribution of the debt by maturity will have in the long-run a substantial effect upon the distribution of short-term and long-term interest rates. The presumption is that a long-term debt instrument which has a long time to go is essentially a less liquid instrument than a short-term one. It is less liquid to the system as a whole, and in a degree it is less liquid to the single small bank, because you cannot predict the price you will be able to realize on it. There is a risk in connection with it. I think long-term government debt is much more a rival to long-term rates that are applicable to private investment. I think, for example, the bill rate can fluctuate through a far wider range without affecting mortgage availability than can long-term government bonds. The long-term corporate bond issues are much more closely geared in price to the long-term yield on U.S. government issues than they are to the bill rate. I do not think you can have just any curve in interest yields in terms of short and long which

has discussed this adequately as most people and I think you were quite fair in saying that the conclusion is in terms of monetary policy. When you came to the issue in with the other point you were discussing this morning, and that is the question of liquidity and the extent to which, by varying the maturity structure of existing debt, liquidity is affected.

PROFESSOR SAMUELSON: I think the distribution of the debt by maturity will make in the long-run a substantial effect upon the distribution of short-term and long-term interest rates. The presumption is that a long-term debt instrument which has a long time to go is essentially a less liquid instrument than a short-term one. It is less liquid to the system as a whole, and in a sense it is less liquid to the average small bank, because you cannot predict the price you will be able to realize on it. There is a risk in connection with it. I think long-term government issues have been subject to long-term rates that are applicable to private investment. I think, for example, the bill rate can fluctuate through a far wider range without affecting mortgage availability than can long-term government bonds. The long-term corporate bond issues are much more closely geared in price to the long-term yield of U.S. government issues than they are to the bill rate. I do not think you can have just any curve in interest yields in terms of short and long which

you want. Certainly if you will the need you must will the means, and you must also take massive changes in the amount of market long-term issues. I am not making the suggestion that with a small departure from bills only you will get a tremendous advantage. With a small departure from bills only you will get a small advantage. I suspect in the long run it is not a negligbly small advantage.

There is a slight problem in the United States as to whether in the construction field certain of the instrumentalities set up by the government are not acting a little bit like a second central bank. I have in mind the borrowing organizations of the Federal Savings and Loan Association, which lends money; it makes money available to its members in much the same way that discounting makes money available to ordinary commercial banks. Now, I think that should be co-ordinated. There should not be two independent wills in the system involving possible conflicts, one undoing the work of the other. It seems to me that by consolidating these two into what we call a central bank, the combined operations will have an effect on the liquidity relevant to the housing area much more powerful than just a change in the short-term bill rate. The same is true with respect to the international competition for funds.

It was mentioned to me as we were breaking up for lunch that a change in the reserve rate against savings deposits or time deposits had

been announced just this morning in the United States. I do not know if this is a correct fact, but let us suppose that it is and that it was reduced from 5 per cent to 4 per cent on the supposition that the Federal Reserve wants at this time to ease money a little. I hope that is what they want because all the business indicators are in a somewhat apprehensive state. This seems to me to have been a very good thing to have done, for the good it does to the domestic investment. It will probably cause less leakage of funds abroad than a similar release of millions of dollars in an area that involves the big wholesale banks in New York. Their customers must properly always look to the London bill rate in comparison with the American bill rate and shift when there is a differential. This is not what I call hot money. I think it is better called cool money. It moves with respect to the differentials.

It seems to me that the savings banks which are affected by this particular change, are the most likely not to be in the market; or again, commercial banks with large savings deposits such as the small banks in the part of the country that I know best, will not send money abroad and we can have more expansion with less danger to the balance of payments. This is precisely the kind of liquid operation that the good part of the Radcliffe Committee was aiming at -- which would be thrown away by the very narrow conception of a

[illegible]
I do not know if this is a correct fact, but let us assume that it is so; that it was between from 5 per cent to 3 per cent of the expenditure that the National Resources would at this time be able to carry a little. I have said [illegible] all the [illegible] in a comprehensive [illegible]. That seems to me to have been a very good thing, as I have done, for the money it does to the domestic investment. It will probably cause less leakage [illegible] abroad than a similar volume of millions of dollars in so far that [illegible] the big [illegible]. [illegible] not what I call [illegible]. It would [illegible].

[illegible] which [illegible] the most likely not to be of the [illegible] commercial banks which [illegible] savings deposits, even in the small towns in the part of the country from I come from, will not send money abroad and it is to have more expansion with less danger to the balance of payments. This is precisely the kind of liquid question that the good part of the Radcliffe Committee was aiming at -- which would be thrown away by the very narrow conception of a

central bank -- as this is affecting the neutral money at the shortest end, regarding it as the province of the free market to adjust the differentials. Most of the differentials can be adjusted by the free market, and ought to be, but I think it can use a little help within the framework of law and responsible government for the purpose of stabilization and long-term economic development.

COMMISSIONER BROWN: In your brief you made it quite clear that in your opinion the treasury when selling a bond issue had to in fact disregard its cost as an element in its decision, and that its decision should be made based on monetary effects with the whole ----

PROFESSOR SAMUELSON: Excuse me, I hope I did not say "disregard its cost". It ought to count the cost and then incur it ---

COMMISSIONER BROWN: I am sorry.

PROFESSOR SAMUELSON: Not and consider that this was no objective at all. It should balance that cost against the advantage.

COMMISSIONER BROWN: Yes. I rather gathered that this should be subserviant to the main objective, monetary policy as a whole?

PROFESSOR SAMUELSON: Yes. If I were to make a charter for debt management I would specifically say that ideal debt management is not that which over the business cycle minimizes the cost of debt services.

[illegible] — as this is affecting the [illegible] money at the shortest end, regarding it as the position of the free market to adjust the differentials. Most of the differentials can be adjusted by the free market, and ought to be, but I think it can use a little help within the framework of law and responsible government for the purposes of stabilization and long-term economic development.

COMMISSIONER FROMM: In your letter you made it quite clear that in your opinion the Treasury when selling a bond issue had to in fact disregard the cost as an element in its decision, and that the decision should be made based on economic effects, you said —

PROFESSOR SAMUELSON: Excuse me. I hope I did not say "disregard its cost". It ought to count the cost and then ignore it —

COMMISSIONER FROMM: I am sorry.

PROFESSOR SAMUELSON: Not and conclude that this was no objective at all. It should balance that cost against the advantage.

COMMISSIONER FROMM: Yes. I rather gathered that this should be subservient to the main objective, monetary policy as a whole?

PROFESSOR SAMUELSON: Yes. If I were to make a summary for debt management I would specifically say that ideal debt management is not that which over the business cycle minimizes the cost of debt service.

The ideal debt management is one which achieves the greatest stabilization over the cycle and the best long run development at the same cost in terms of debt service costs.

In the United States there is an illusion on the part of some people that the secretary of the Treasury determines expenditure. I do not know how that idea could have grown up even in the sense of policing expenditure. In the United States it is the Bureau of the Budget and the Director of the Bureau; but <u>his</u> job is not to cut down on the armed services, say, but to co-ordinate the will of the government. The job of good government is not to cut down on government expenditure but to have the <u>right</u> amount of expenditure. The same with respect to debt services. Like any other expenditure it should be incurred in a good cause, and one good cause is to have the proper maturity structure of the debt, as part of good stock management for the purpose of business cycle and development control.

COMMISSIONER BROWN: This means that at times he will be selling at the peak of interest rates?

PROFESSOR SAMUELSON: Yes, that is right.

COMMISSIONER BROWN: And at other times he will be selling at the bottom of interest rates?

PROFESSOR SAMUELSON: That is right. And it probably means that the proper time to lengthen the debt is when it will cost the most money.

I want to express my disagreement with the position of the Joint Economic Committee Majority Report on this subject, which said that there is no particular potency in debt distribution anyway, so a good time to lengthen the debt is during a sloppy recession market when interest rates are very low, and it can be done most advantageously.

My view is the reverse.

COMMISSIONER BROWN: This is no long-term problem for him or even a short-term problem. He is selling the most expensive debt for the longest period of time?

PROFESSOR SAMUELSON: I think that is a desirable thing to do. If one took seriously the notion that the best debt maturity is that which minimizes the service cost to the government, then you ought to issue greenbacks, not interest-bearing money. I may say that the printing of greenbacks which is the privilege we give to the central bank -- most modern governments do not choose to use it itself; they have a go-between which does it -- can sometimes be the correct thing to do. But you want to do it only when what the economy needs for stabilization of long term development purposes is a larger amount of M in the sense of cash, as against near M in the sense of bills, or as against slightly further M in terms of long-term bonds.

COMMISSIONER BROWN: Does the same principle hold that when interest rates are at their lowest you should sell the shortest? This

obviously creates embarrassment to him when he is next on the market.

PROFESSOR SAMUELSON: It would often be the advice I would give, but for the reason that when interest rates are lowest, is typically the time when the economy has a vast amount of unused resources and you want the greatest expansion effect from your stock operation or monetary policy, and you get that by short term.

COMMISSIONER BROWN: And by increasing the liquidity?

PROFESSOR SAMUELSON: Yes. But I do not subscribe to a view which is popular amongst some continental writers and bankers, particularly the older ones, that floating debt itself is about as evil as greenbacks. It is funny that people who deal with money most sometimes have the view that it is the worst thing in the world for there to be. I think that a large amount of floating debt is a normal accompaniment of a modern system like the United States, in recession times, in excessive boom times, and also in conditions of prosperity, with more or less stable prices.

May I make it clear that I am interested in reducing debt service charges, all other things being equal, as part of good management. One of the ways to reduce debt service charges is by properly catering to the desires of the market. This does not mean that the market place tells you what you ought to do, but if insurance companies have a great need

[illegible]

[illegible] in the market.

PROFESSOR S[illegible]: It would [illegible]

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COMMISSIONER [illegible]: And by increasing the liquidity?

PROFESSOR SAMUELSON: Yes. But I do not subscribe to a view which is popular amongst some conservative writers and bankers, particularly the older ones, that floating debt, "bad" in general as well as governments. If it really [illegible] to deal with money most economists have the view that it is not worth being in the market for [illegible]. I think that a large amount of floating debt is a normal accompaniment of a modern system like the United States, in recession times, in expansive boom times, and also in conditions of prosperity with more or less stable prices.

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for a bond which would not be callable for ten years, and they are willing to pay for the privilege of playing safe for ten years from now, then the astute secretary of the Treasury will issue the type of security which creates the greatest good all round. That is making them pay for the privilege. So that there should be no unnecessary enlargement of debt service, because debt service, although a necessary evil, is an evil.

I do not like in the American system to have to raise $10 million fixed taxes every year for this purpose. But we do live under law and order, and people who bought the bonds bought them in good faith. I am not in favour of a capital levy or an expropriation of them, and I think it is very well worth the price that we have to pay.

COMMISSIONER BROWN: That is all I had on that.

COMMISSIONER MACKINTOSH: Professor Samuelson, I should like to direct your attention for a little while to the international side. We are accustomed here to think that we have a very open, not to say windy, economy, and putting aside the question of degree, how far in such an economy do you think you can find any criterion for monetary policy other than your international bonds and your international flows? In other words, how significant is a domestic monetary policy aside from the external?

PROFESSOR SAMUELSON: Leaving out the

for a high enough [illegible] years,

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COMMISSIONER [illegible]: That is all I have on that.

COMMISSIONER MACKINTOSH: Professor Samuelson, I should like to direct your attention for a little while to the international side. We are accustomed here to think that we have a very open, not to say windy, economy, and putting aside the question of [illegible], how far in such an economy do you think you can find any criterion for monetary policy other than your international bonds and your international views? In other words, how significant is a domestic monetary policy aside from the external?

PROFESSOR SAMUELSON: Leaving out the

problem of objectives and sticking to the problem of the factual choice open to you, the smaller you are, the more open an economy you have, the less scope you have for an independent policy. This would be obvious if you thought of a province of Canada which tried to have central banking operations and who set the rate of interest it wanted. I do not suppose that any bank in Canada would be foolish enough to believe that.

COMMISSIONER MACKINTOSH: You might be surprised!

PROFESSOR SAMUELSON: Well, you would find a leakage abroad very rapidly, and I think the testimony given before you by Professor Lundberg of Sweden, and by Dr. Holtrop of the Netherlands Bank is very relevant in this connection. On the other hand, I think you have a measure of autonomy, and it is within that measure that you would work. Furthermore, this has a bearing upon what the rules of the game are. (1) Do you operate within the framework of a fixed exchange rate standard? (2) What is the situation with respect to your capital market?

Now, I have read with great interest Professor Lundberg's discussion of the Swedish situation. He pointed out in a very matter of fact way, because it is one of the facts of life which he has always known, that there has been almost no capital investment into Sweden. I had not realized that until last May when I was lecturing

in Stockholm. I learned it with great surprise. I also learned what he did not mention, -- but perhaps it came out during his oral testimony -- that it was because the Swedes do not allow capital investment. Standard Oil of New Jersey cannot go into Sweden and buy up an existing network of filling stations. It can do that in Belgium. It can do that in France. It can do that in the U.K. But it cannot do that in Sweden. When I was in Sweden, with great generosity the government permitted a large canning operation to merge with a Norwegian canning operation, probably because they were nice Scandinavian Norwegians and this was permitted. I think that that is one of the reasons which would explain Lundberg's problem. He said: How is it that our federal government has not been able to contrive a balance of payments crisis in the post war period since 1947, and we are the most open economy imaginable because we have low tariffs? I think if you had Swedish provinces and they went to a nearby market to borrow at their discretion, there might have been a different situation there. Particularly for a country like Canada, living -- I will not say in the shadow of the United States, -- in close proximity to the United States, you have to specify to me just exactly what will be the freedom of different people to borrow, and what would be their habits. That being the case, you will find a lot of credit policy is determined not by the federal treasury but by some of your

provincial treasuries, and by some of your very large corporations. There is a discipline imposed by the international balance of payments problem for every country. The only exception I know is the United States. From 1933 until about 1958, the United States -- and I went to every meeting in Washington and I have read the record every day -- had no great concern about a balance of payments problem except to help the other fellow. It was a honeymoon which lasted much longer than most honeymoons are expected to last, but now it is over. We have rejoined the human race and we too have a balance of payments problem. As Per Jacobsson said, Providence did not give the United States permanently an immunity from these various problems.

I think that if I were a small nation and I were somewhat dependent upon staple products like forestry, uranium, and various mining products, and I had open to me the option -- which is not open in the United States -- of a floating exchange rate, I might take up that option. I do not think the United States is in a position to let its exchange rate float because the rest of the world would not let it happen. A small country might be in the position where the rest of the world would let it happen, and I think that certain advantages and a certain increased freedom could come to monetary policy in such a régime. If the freedom is the freedom which is going to be abused and the freedom which will not make corrections in the economy

[illegible] treasuries, and by some of the very large corporations. There is a discipline imposed by the International Balance of Payments position for every country. The only exception I know is the United States. Since [illegible] about 1950, the United States -- and I want to speak frankly in Washington and I have said this [illegible] -- had to worry very little about a balance of payments problem except in very [illegible] periods. It was a [illegible] which [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]. We have [illegible] the [illegible] and we have a balance of payments problem. As [illegible] [illegible], Providence did not give the United States permanently an immunity from these [illegible].

I think that if I were a small [illegible] and I were somewhat [illegible] [illegible] [illegible] like [illegible], [illegible], and [illegible] [illegible] and I had open to me the option -- which is not open to the United States -- of a floating exchange rate, I might take up that option. I do not think the United States is in a position to let its exchange rate float because the rest of the world would not let it happen. A small country might be in the position where the rest of the world would let it happen, and I think that certain advantages and a certain increased flexibility would come to monetary policy in such a regime. If the exchange is the [illegible] which is going to be altered and the [illegible] policy will not make corrections in the economy

which ought to be made, and there is no discipline or substitute for the discipline of the balance of payments, then this is probably going to do more harm than good. Possibly under better management a flexible foreign exchange rate policy, including perhaps a floating rate, gives extra options to the authorities, both for fiscal policy and for monetary policy.

COMMISSIONER MACKINTOSH: If your floating exchange rate does protect you and fluctuates a great deal, are not the penalties fairly heavy? If you have a floating exchange rate which stays pretty steady, then that is all right.

PROFESSOR SAMUELSON: If you have a floating exchange rate and you have in your money market very panicky individuals who seem to be especially prone to listen to every possible rumour, and some sharp operators jump on every movement so that the speculation which you get tends to be not of an informed stabilizing pattern but instead glorifies in accentuating movements, something alleged to be true of some of your small mining stocks -- I now mean equities -- then you could, I think, get almost none of the advantages from a floating exchange rate and you would reap the maximum disadvantage. It would be hard to carry on foreign trade. Every exporter and importer would have to be an arbitrage expert. The premium which would have to be paid for coverage to Loyds, or anybody else, would be very high under those

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[illegible] [illegible]

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I submit, you cannot [illegible] of the advantages that a

flexible exchange, [illegible] you would have the

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would have to go [illegible]

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[illegible], would be very high [illegible].

circumstances, and it would be a dead weight drag on international trade.

Moreover, this could be true of any speculative market because of an extra feature with respect to foreign exchange rates of a country. When I speculate in wheat and I pass rumours around which will make the price of wheat temporarily go up, there is an underlying economic law which says that there is only so much physical wheat and only so much need for wheat, and the boom will come down and will have as its rendezvous some rough economic approximation to the equilibrium level.

In the foreign exchange rate field we cannot be sure of that, for the reason that if you have a very strong bear raid on a currency you might find within the country monetary policies and fiscal policies which accompany that which justify the exchange rates being low permanently. In other words, there is no par to which things return. That means that a bear raid, a speculation, may be successful when it is being destabilizing; whereas in penny Canadian stocks and in the wheat market, on the whole the people who end up making money, unless there is misinformation being spread, are the people who correctly gauge the depths of the mines, the value of copper ore, and the demand for wheat in comparison with the weather in the wheat growing provinces.

In the exchange rate field where there is no par, because of the grain of truth in the

[illegible], and it might [illegible] [illegible] [illegible]. [illegible] [illegible].

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In the exchange rate field where there is no par, because of the grain of truth in the

Quantity Theory of money that we would be no worse off if we had twice as many dollars and twice as high prices, the people who destabilize exchange rates might be in the end rewarded. This is an aspect of the problem which is on the negative balance sheet with respect to floating exchange rates.

The last thing in the world that I want to do is to appear in Canada before experts who knowssomething about Canadian affairs and pontificate about them. But I should have thought that when the Canadian dollar was $1.03 in terms of the American dollar and the Canadian economy was slowing up in its rate of growth, not compared with the American economy but in terms of its per capita rate of growth -- because of lots of external factors, such as the fact that the uranium market was finally giving out, and a number of natural reasons like that -- that would have been in order in those circumstances would not be a forced devaluation of the Canadian dollar from $1.05 to $1.03 and then to $0.99 by some kind of exchange stabilization activity, but rather that the floating rate would have given the central bank the freedom to pursue a more expansionary policy than would have been possible under a fixed exchange rate.

In that circumstance, as the Canadian economy expanded and its imports expanded relative to its exports, the $1.03, without regard to any speculation or nudge by the government directly, would have flowed downward from $1.03 to $1.01,

and even down to $0.98, and stayed at $0.98. That would be, to my mind, using the advantage of a floating exchange rate. I do not know whether in any period of history it has ever worked out like that, or could be expected to work out like that. I would hope that in the future it could be expected to work out.

I might call your attention to one possibility other than a floating exchange rate, freely floating. Professor Phillips, whom I mentioned earlier and who happens to be a visiting professor at M.I.T. from the London School of Economics just for this year, is a very able economist and also a very clever man at thinking up gadgets. Most people's gadgets in economics I do not like, but he has mentioned one possibility here which sounds interesting to me. He said to me: "Why should not some governments, particularly small governments, have a policy that they will permit an exchange rate fluctuation within any one year of a certain magnitude? Let us say it is one per cent a year. One per cent per year is unlikely to stampede speculators, because you cannot make much out of it; but over a ten year period, if your cost level is getting a little out of line with other people, it will help you make adjustments." Now, if you do this, and on the first day of the year you use up your one per cent, then you are right back in the problem. Again, it is a one-way move for speculators. You guess that you are going to be

and used them to [illegible]. That would be, to my mind, using the advantage of a floating exchange rate. I do not know whether in any period of history it has ever worked out like that, or would be expected to work out like that. I would hope that in the future it could be expected to work out.

I might just give another possibility rather than a flexible exchange rate, freely fluctuating. Professor Dornbusch, whom I mentioned earlier and who happens to be a visiting professor at M.I.T. from the London School of Economics just for this year, is a very able economist and also a very clever man at thinking up gadgets. Most people's gadgets in economics I do not like, but he has mentioned one possibility here which seems interesting to me. He said to me: "Why should not some governments, particularly small governments, have a policy that they will permit an exchange rate fluctuation within any [illegible] year of a certain magnitude? Let us say it is [illegible] per cent a year. [illegible] per cent per year is [illegible] to scramble speculation, because you cannot make much out of it; that is not a big profit. If your cost level is getting a little out of line with other people, it will [illegible] adjustments." Now, if you do this, and on the first day of the year you use up your one per cent, then you are right back in the problem. Again, it is a one-way move for speculators. You know that you are going to be

forced through. But if you are a little more subtle than that -- and, by the way, one per cent is not big enough; it depends on the nature of your export industries, I would think, and your capital markets -- I think it would give you many of the advantages of stability for international trade purposes, and some of the advantages over a long period of time of adjustment which can come from differential exchange rates. I do not recommend this to this Royal Commission, but I do nominate it for consideration along with lots of other possible devices.

COMMISSIONER MACKINTOSH: I take it that the central purpose of that is to avoid the disruption of this demonstration of a fundamental disequilibrium to the international monetary fund and a change of par values?

PROFESSOR SAMUELSON: Yes.

COMMISSIONER MACKINTOSH: It is a sort of instalment plan?

PROFESSOR SAMUELSON: Yes. It is not as if we really stick to the old rules of the gold standard and have internal flexibility of wages going up and down. What happens is that in effect we insist on rigid wage rates.

[illegible] [illegible] big enough: It depends on the nature of your export industries. I would think, and your capital markets -- I think it would give you many of the advantages of stability for international trade purposes, with none of the advantages over a long period of time of adjustment which can come from flexible exchange rates. I am not persuaded that [illegible] this Royal Commission, but I do recommend it for consideration along with [illegible] of other possible devices.

COMMISSIONER MACKINTOSH: I take it that the general purpose of that is to avoid the disruption of the accumulation of a fundamental disequilibrium in the international monetary [illegible] and a change of par values?

PROFESSOR SAMUELSON: Yes.

COMMISSIONER MACKINTOSH: It is a sort of instalment plan?

PROFESSOR SAMUELSON: Yes. It is not as if we really stick to the old rules of the gold standard and have internal flexibility of wages going up and down. What happens is that in effect we insist on rigid wage levels.

COMMISSIONER GIBSON: May I interject a question at this point?

THE CHAIRMAN: Yes, certainly.

COMMISSIONER GIBSON: Professor Samuelson, you gave a very interesting hypothetical question on the Canadian situation. You deliberately said it was hypothetical. Supposing we had an exchange rate of $1.03. This would give you an opportunity to pursue a monetary policy of a more expansionary nature. You would be free to do this.

PROFESSOR SAMUELSON: Yes.

COMMISSIONER GIBSON: If you add to that a country running very large balance of payment deficits, which I think would be generally recognized as being an undesirable picture, would that change your conclusions very much or would it change them at all?

PROFESSOR SAMUELSON: I think in that case, if you have the freedom to have a floating exchange, it would seem to me that under that circumstance, if there was a permanent deficit in the balance of payments that looked as if it were due not to temporary reasons-- in other words, in Australia if the wool crop in one particular year is bad there are great strains imposed on the balance of payments, and the central bank will help them right through -- say, if you felt that the cost structure of a country like Canada was getting out of the line and was not likely to get into line soon, then I would certainly think that would be the best

occasion for not, by austerity at home, preserving the $1.03 exchange rate through a tight monetary policy. Nor would I even think it a very good thing to bridge the gap by borrowing abroad, as you can do if you generate high interest rates at home. That short-term relief puts off the day of adjustment. I am not wholly facetious when I say that I think all this is hypothetical; perhaps I make reference to a country like Aleutia, or some other textbook name, because I don't know enough about the Canadian situation of a few years ago, although some people would think my analysis just fits to state with confidence that what I am saying is applicable to Canada as against some other view. I would have a suspicion, though, that there may have been that opportunity.

COMMISSIONER GIBSON: We also had a persistent and very large balance of payments deficit.

PROFESSOR SAMUELSON: Yes. In response to a question by Dr. Mackintosh who asked me, I think, if you found you had a very obstreperous market of speculators and not only a windy economy but windy speculators who got their wind up very easily and reacted upon each other -- let me say that if I had a floating exchange rate I would put a good deal of weight upon a stabilization board in the country which would counteract that situation and would even teach the rascals a lesson occasionally in a way very painful to them.

You cannot do that if you have nothing in your coffers. You have to start out with enough foreign exchange to be able to operate, for sometimes when you try to punish them it is going to take a good, hard campaign to do it. You better be sure you are loaded for that. There is no reason why, if you have a floating exchange rate, you cannot insist that it float very gently, for then you are just back to where you were with a stable exchange rate. A stable exchange rate is a floating exchange rate that is not allowed to float at all or only allowed to float between very narrow gold points.

Many people have suggested there be a widening, if necessary an artificial widening, within the gold points in which exchange rates fluctuate. I believe that in one of his incarnations Mr. Keynes in the 20's suggested that. I do think that people are a little optimistic to believe a slight widening of the exchange rates will handle a fundamental disequilibrium. If you have a real disequilibrium, you can't have very much confidence that you letting the British pound fluctuate from $2.90 to $2.70 as against $2.82 to $2.78 will cure it; but it is quite good for short-term seasonal fluctuations and other things like that.

COMMISSIONER MACKINTOSH: I do not want to examine this in great detail but what is your view on the adequacy of international liquidity in these days of various proposals for enlarging immediately or ultimately?

PROFESSOR SAMUELSON: If the principal nations of the world could get together with the International Monetary Fund after a good deal of private consultation of government officials and central bank officials, and set up a more formal arrangement involving a larger amount of reserves, I think that would be a very good thing. That does not mean I agree with the Triffin Plan or any particular type of plan, but I think it would be a good thing not merely because the quantum of real world trade is growing very fast compared to the quantum of money that our present gold mining and instruments provide, but because the countries of the world and their balances of payments in the world, it seems to me, are out of kilter somewhat in respect to each other, and larger reserves would be very helpful in easing the situation.

There may be a day ahead when that quantum of world goods becomes so much greater than the amount of the gold increase that you will have to have very high stilts on the gold, and if you do not do it in a formal arrangement you will have stilts that wobble and are not quite long enough, and there will therefore be a drag upon world trade. I do not think we are yet in that particular position, and so it is not for that reason at the moment I would be most in favour of such an expansion. But I am in favour of expansion, and one of the by-products of that would be good. It would be a bad thing, however, if it just resulted

[illegible]

[illegible] in favour of expansion. [illegible] and one of the [illegible] would be good. It would be a bad thing, however, if it just [illegible]

in thoughtless finance.

COMMISSIONER MACKINTOSH: In what?

PROFESSOR SAMUELSON: Thoughtless finance and just used as an occasion to give irresponsible government more rope to create internal demand pull inflation. I do not think demand pull inflation has been a problem in the United States, and I suspect it has not been a primary problem in Canada. But there are other parts of the world where the diagnosis might well be different.

COMMISSIONER MACKINTOSH: It certainly has not been here recently.

PROFESSOR SAMUELSON: No, it has not been recently, but it is possible that what is going on in Continental Europe where money wages in, say, Germany are rising more than 10 per cent a year and productivity is rising but not by anywhere near that amount, is accompanied by some elements of demand pull. I do not want to wish inflation on my neighbours but if they persist in it for a little while, I guess we will be able to tolerate it!

COMMISSIONER MACKINGTOSH: The same argument can be made that a little inflation in the United States might ease our position.

COMMISSIONER LEMAN: Mr. Chairman, there is one very short question I should like to ask Professor Samuelson. It refers to the last sentence of your Section 12 on page 28. You have

In one very short question I should like to ask Professor Samuelson. It refers to the last sentence of your Section 1c on page 8. You have

explained that central banks started as being really super-commercial banks with a priority of privileges over others and gradually they really became public institutions. In the last sentence, though, you write:

"Profit maximizing is at least a definite task and its disappearance makes the job of decision-making all the more ambiguous and difficult."

Is there a little nostalgia in there?

PROFESSOR SAMUELSON: No, I just had in mind that I would rather run a sweat shop or a department store than the Ford Foundation, just from my own personal decision-making ease, because each day you would come back from the sweat shop or department store and you would say, "Another day, another dollar". In deciding whether to stock certain merchandise you would ask yourself the question, "Will it pay?" That is a crispness which is very helpful for decision-making, but if you are running the Ford Foundation you are giving away money, and the most difficult thing in the world is to score yourself on whether you are giving away the money well. The business of the central bank is not to give away money but it is to achieve the common good in the macro-economic field, and there is no cash register which shows you every day just how you are doing. That is all I had in mind there. It would be terrible if the central bank went back to its primary concern in terms of making money,

for money will not manage itself.

COMMISSIONER LEMAN: May I ask you this other question. I am not referring now to times when you must be careful. For instance, you mentioned the present balance of payments position of the United States which forces that country to adjust itself to certain difficulties.

PROFESSOR SAMUELSON: Yes.

COMMISSIONER LEMAN: But in general would you say that governments have been a little timid about trying things in this field?

PROFESSOR SAMUELSON: Do you mean trying for new instrumentality and gadgets?

COMMISSIONER LEMAN: Testing techniques by going a little further than they felt they should go but just to get more information about the workings of the various techniques used?

PROFESSOR SAMUELSON: I have a slight feeling in that direction. I am very happy that the present Under-Secretary of the Treasury, Robert Roosa, is trying out a whole set of new things. He is even having the government issue underwritten by private investment banking firms the way an issue by a large company would be underwritten. I do not think we have the last word in this respect. I have endeavoured in my submission to you not to humour my desire for new experience. However, I would like the experiment in which you let the discount rate move with the bill rate, because I might learn something as an economist from it. It is the same

for money will not mature [illegible].

[illegible]: May I mention some other questions. I am not referring now to those which you raised in detail. [illegible], you mentioned the present balance of payments deficit as one factor which might prompt this country to adjust [illegible].

[illegible]: Yes.

[illegible]: But in general would you say the government have been a little timid about trying things in this field?

[illegible]: As you mean, trying new [illegible] and methods?

[illegible]: [illegible] by [illegible] [illegible] of the [illegible]?

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feeling I have when M.I.T. builds a building, particularly if it is not an economics building. I would like to have them get a good architect and take some risks; for the whole world learns from new kinds of architecture and it is but a part of our burden not to build something just like what everybody else builds. But I have tried to be a responsible witness here and not have Canada's well-being sacrificed to my thirst for knowledge; but I must confess at the subconscious level I do have that feeling because I do not think we have found that the pioneering is over in the field of finance.

I can illustrate that by a number of cases. For instance, there is Governor Strong's stumbling on open-market operations. People did not really know about them or understand them. That was a very good find. Or let us take a bankrupt railroad in the United States -- and there are too many of them. They could get diesel engines at about 5 or 6 per cent even when their credit was worthless, and this was because somebody thought up equipment certificates: you could use the diesel engine, which was transferable as a chattel mortgage, and transfer it. Now, that did more for railroad financing, for dieselization, than any conventional central bank. I congratulate Chairman Martin and Secretary Dillon and Under-Secretary Roosa that the American government has been quite daring with respect to changing interest ceilings

feeling I have very mildly, being a realist, [illegible] I would like to have them get a good architect and take some risks; for the whole world learns from new kinds of architecture and it is not a part of our program not to build something just like what everybody else builds. But I have tried to be a responsible [illegible] people's well-being [illegible]; so I must confess at the unconscious level I do have that feeling because I do not think we have found that the [illegible] in the field of finance.

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on time deposits.

Many of the special interest groups in housing were very concerned that if you let savings banks pay higher rates of interest, this would choke off credit and would be part of a hard credit policy. However, it actually makes more credit available than would otherwise be the case; but it did involve risk and experimentation. It is a risk that has paid off. The departure from bills only by Operation Nudge did not do as much for residential housing financing as the act of changing the interest ceilings for time deposits did; but it has been good for residential financing in this rather weak recovery period when we have needed help in the residential construction picture. Therefore, I must say that I do think that a little trial and error and experimentation is in order.

COMMISSIONER LEMAN: Are there people in the United States who feel that a tax reduction at this time would be a very dangerous thing and could do great harm?

PROFESSOR SAMUELSON: There are a number of people who think that. A number of them say they do not believe it, but there are other people in Zurich who do believe it. I know from talking with Continental bankers that they sometimes experience some embarrassment in New York and Boston because their genial hosts say to them, "You are very worried about or deficit

Royal Commission on Banking and Finance

PROFESSOR PAUL A. SAMUELSON

Hearings held at OTTAWA

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Official Reporters
F.J. Nethercut and R.J. Young
Toronto, Ont.

MEMORANDUM

for

THE ROYAL COMMISSION ON BANKING AND FINANCE, CANADA

Paul A. Samuelson

October 19, 1962.

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

1. Introduction. As an economist who has studied for some considerable time problems involving money, credit, banking, aggregate output, price levels and international finance, I am glad to give briefly my views on certain basic policy and institutional problems in the field of central banking, fiscal policy, debt management and international finance. It is evident that I am not an expert on the peculiarly Canadian aspect of these problems, and it is with some diffidence that I touch on those special features of the Canadian case that seem too important to ignore. Because of space limitation, much of the discussion will lack the subtle qualifications that would be appropriate to a more leisurely survey, and that might be developed in oral interrogation. (The fine-print paragraphs, which can be skipped, contain some elaborations.) Finally, because I speak only for myself and as a professor of economics, I may possibly be forgiven resort to pungent language denied to those in official position. Here then is a brief summary of my views on a number of the important questions that have been under examination and discussion by authorities in the general field of monetary policy.

1. Introduction. — As an economist who has studied for some years the problems of central banking, money, credit, banking supervision, public finance and international finance, I am glad to give briefly my views on certain broad policy and institutional problems in the field of central banking, fiscal policy, debt management and international finance. It is evident that I am not an expert on the peculiarly technical aspect of these problems, and it is with some diffidence that I touch on purely technical features of the questions, once they seem too important to ignore because of their implications. Much of the discussion will lack the exact qualifications that would be appropriate to a more intensive survey, and that might be developed by full interrogation. (The time available, which can be secured, permits some such qualification.) Finally, because I speak only for myself and as a professor of economics, I may perhaps be permitted freely to suggest certain points of view on controversial questions. Here then is a brief summary of my views on a number of the important questions that have been under examination and discussion by authorities in the general field of monetary policy

I. General Powers of Monetary Policy

2. Monetary policy potent. Contrary to the opinions of many contemporary economists (and to some of my own earlier views) I believe that monetary and credit policies have great potency to stimulate, stabilize, or depress a modern economy. This belief is based on my evaluation of the tremendous amount of empirical data thrown up by (1) history, (2) current statistics and (3) case studies of business behavior. These data are diverse, conflicting, and often inconclusive and have therefore to be interpreted with the help of all the tools of economic analysis inherited from the past and developed by the present generation of scholars.

3. Money not all-important. In thus differing from the pessimists, I want to make clear that I am not agreeing with that much smaller group of older economists who think that monetary policy by itself is the sole or principal mechanism for controlling the aggregative behavior of a modern economy. I believe such a view to be factually wrong or irrelevant; and would add that even if monetary policies truly had this exaggerated degree of potency, I would not deem it optimal social policy to rely exclusively or primarily on that weapon alone.

4. Money a social responsibility. Today all experts dismiss the ancient view that laissez-faire can properly hold in the field of money and banking. "Money will not manage itself." Banking institutions

[illegible]

4. [illegible]

1. [illegible]. Relying on the writings of many contemporary economists [illegible] of my own earlier views, I believed that monetary and fiscal policies have great powers to [illegible], stabilize, or [illegible] economy. This belief is [illegible] of the [illegible]

[illegible]

2. [illegible]. In [illegible]

[illegible]

3. [illegible]

[illegible]

are not perfectly-competitive self-regulating enterprises that can be free from strict governmental regulations and controls. They are "public utilities vested with public interest" and the same is true in equal or lesser degree of various financial intermediaries such as saving institutions, finance companies, insurance concerns. Let me make clear that all this is stated from the standpoint of one who pilosophically values individual freedoms. A person who cheerfully accepts the idea of direct price, wage, and production controls can afford to give a relatively large measure of freedom to credit institutions; but one who wishes to minimize (except in emergency periods) the use of such direct controls will realize that we maximize total freedom in a society by limiting it in the areas which crucially determine the aggregate of effective demand. In summary:

> A responsible policy of government control of monetary <u>and</u> fiscal policy is a primary weapon in the battle for a well-running market economy.

5. <u>The folly of simple formulas</u>. I must firmly disassociate myself from the small but important group of writers who, agreeing that money will not run itself, go on to argue that it ought to be determined permanently by certain automatic formulas. Sometimes this is put in the fancy language of "rules versus authorities," or "laws versus men" or, "automaticity versus discretionary action." Of course no one,

[illegible]

[illegible]

[illegible]

myself included, will admit to favoring arbitrary caprice of bungling rulers over the even-handed justice of well-formulated rules. If every form of explicit cooperative action set up by men is bound to be completely nearsighted, venal, and blundering then recourse to astrological rules might pragmatically be defended -- although no wise man could have any secure belief that such bungling human beings would ever bind themselves and stay bound to such arbitrary mechanisms. The vicissitudes of ancient coin standards -- which were at the mercy of the accidental discovery of precious metals in Latin America, Australia, California, Alaska, South Africa, and now Soviet Russia -- would certainly be preferable to some forms of "managed money." In practise though, there have always been -- both for good and evil -- substantial departures from any automatic coin, bullion or other kind of gold standard. In principle the choice has never been between discretionary and non-discretionary action: for when men set up a definitive mechanism which is to run forever after by itself, that involves a single act of discretion which transcends both in its arrogance and its capacity for potential harm any repeated acts of foolish discretion that can be imagined. Since I have argued elsewhere (1,2,3) the philosophical principles involved in this choice and have never seen any written refutation of these arguments by adherents of the "automaticity" school I shall merely state here that the relevant choices have to be made pragmatically in terms of the goodness

or badness of behavior patterns that result from various kinds of discretionary action.

6. <u>The folly of a pre-ordained stipulated trend in money supply</u>. Specifically consider the suggestion of a money supply which is to grow at exactly 3 per cent per year, a policy advocated by some who think no other actions would then be required. Suppose this had been enacted in the United States in a random recent year without knowledge of the balance-of-payments problems just ahead and without knowledge of the massive shift to time deposits such as we have been experiencing both as a result of raised interest-rate ceilings on such deposits and the natural shift to such deposits as interest rates generally rise. The results could have been quite bad in comparison with what actually happened; and if the balance-of-payments situation had for unpredictable reasons been a great deal worse, the results could have been disastrous. I realize the adherents of such proposals will argue: such dire results might have been avoided if there had been floating exchange rates, perfectly flexible wage rates, and never, never any interest-rate or other ceilings. But since we do not and shall not live in such a never-never land, legislating part of the package would surely do more harm than good.

7. <u>Money control and aggregate spending.</u> There are thousands of reasons why any automatic gadget can be improved upon by decision-makers, even by fallible decision-makers. This statement will be

denied by those who are firm believers in the ancient Quantity Theory of Money. If it were true in a causal sense that there is an invariant relationship between, on the one hand, total dollar income and spending, and, on the other, the supply of money defined in such a way as to be capable of predetermination by the central bank, then an autogyro which kept total money supply growing smoothly would, by hypothesis, keep total money income growing smoothly. While I know that some modern scholars have tried by historical studies to establish an empirical concomitance between money supply and aggregate income, let me simply state here that I find the implied proof of a simple, controllable causal proportionality relationship unconvincing.

8. Ability of change in general monetary conditions to affect total spending in the desired direction. It is the easiest sport in the world to shoot down any crude formulation of the Quantity Theory. But I think it quite illegitimate to conclude from this what the Radcliffe Committee and many modern scholars have stated: namely, if total money supply, M, does not invariably create an exactly proportional total income and product $\Sigma p_j q_j = P \times Q$ -- because, as they so nicely put it, the income velocity of circulation of money, V, is not a constant -- it follows that we should turn our attention away from conventional central bank controls and rely instead on some global concept of "liquidity." As will become evident, I attach considerable importance to various concepts

[illegible]

on the one hand, total income and expenditure, and, on the other, the supply of money defined in such a way as to be capable of quantitative control by the central bank. [illegible]

3. Shifting the emphasis to general liquidity

[illegible] liquidity. [illegible] Theory. [illegible] M, does not [illegible] total income and product [illegible] -- because, as some [illegible] put it, the income velocity of circulation of money, V, is not a constant -- it follows that we should turn our attention away from conventional central bank controls and rely instead on some global concept of "liquidity." As will become evident, I attach considerable importance to various money's

of liquidity. But I think it wrong to believe that recognizing such concepts should undermine the belief that conventional central bank operations of open-market purchase and sale of securities, discount lending, and reserve-rate changing are likely to have important effects upon the total of investment and consumption spending. Emphasizing "liquidity" quite properly serves to debunk a crude quantity theory, and it thereby scores a fatal point against advocates of simple automaticity gadgets. But it leaves the position I am here expounding unscathed and it is for this reason that a number of reviewers have criticized the Radcliffe Report. (The average quality of all the reviews of Radcliffe is probably lower than that of the document itself; among the best reviews, I should like to mention that of Professor John Gurley of Stanford in the American Economic Review, Vol. L, No. 4, September 1960.)

a. Because of the human temptation to reify any concept that has been defined and to tend to think as approximately constant the last variable that one has defined, I do not find the velocity variable, V, a very useful one. But older economists did, and some younger ones are beginning to again. So I shall restate the heart of the matter in such terms. If the requisite V were a strict constant, P×Q would by hypothesis be exactly proportional to the requisite definition of money, M. Experience shows that V is not a

in [illegible]. The [illegible] is being [illegible] [illegible] [illegible] the belief that conventional central bank operations of open market purchase and sale of securities, discount lending, and reserve-ratio changing are likely to have important effects upon the level of investment and consumption spending. Emphasizing "liquidity" rather [illegible] [illegible] [illegible] [illegible] [illegible] and [illegible] [illegible] a [illegible] point against [illegible] of a [illegible] [illegible]. [illegible] [illegible] [illegible] the [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] that [illegible] a [illegible] of [illegible] and [illegible] the quantity theory. [illegible] [illegible] [illegible] of [illegible] [illegible] [illegible] [illegible] [illegible], [illegible] [illegible] [illegible], I would like to [illegible] [illegible] Professor [illegible] [illegible] of [illegible] [illegible] the [illegible] [illegible] [illegible], Vol. [illegible], No. [illegible] [illegible] [illegible].)

a. Because of the [illegible] [illegible] [illegible] velocity and [illegible] [illegible] has been [illegible] and to [illegible] [illegible] approximately constant [illegible] that [illegible] [illegible] [illegible] [illegible]. I [illegible] [illegible] the [illegible] [illegible], V, a very [illegible] [illegible] [illegible] [illegible], and [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]. [illegible] I [illegible] [illegible] the [illegible] of the matter in each [illegible]. If the [illegible] V were a [illegible] [illegible], [illegible] would [illegible] [illegible] [illegible] only [illegible] to the [illegible] definition of money, M. Experience shows that V is not a

constant: it shows certain historical trends in the long run; in the course of the business cycle, it has generally shown fluctuations that are sympathetic with the cycle itself, rising in good times and falling in bad; after more studies have been made, I believe V will also show certain fluctuations with interest rate and other conditions, tending other things equal to rise when interest rates are high and the opportunity cost of cash balances is great and tending to fall when short term investment opportunities all have a very low yield; the behavior of V will also be quite sensitively affected by the particular concept of the money supply that is adopted, being quite different if currency alone is considered (as with the nineteenth century Currency School and Edwin Cannan in the 1920's) than if demand deposits are included and various categories of time deposits and close money substitutes are or are not included in the definition of money. Some of the movements of V will be erratic and relatively unpredictable; others will be in some measure predictable. In particular, although they are operationally hard to identify in the empirical record, there can always be expected certain changes in V that are themselves <u>induced</u> by the change in M itself and, certain other things being held constant, are part and parcel of such a change in M. Some sensible probability statements can be made about these induced changes in V at various phases of the business cycle and at various time points in history. Now if it were the case that recognition of the

conditions). It seems certain [illegible] that in the long run, in the course of the business cycle, it has [illegible] the cycle itself, rising in good times and falling in bad. After more studies have been made, I believe it will also prove certain [illegible] and other conditions, tending [illegible] to rise when interest rates are high and the opportunity cost of cash balances is great and, tending to fall, when [illegible] tell [illegible] of V [illegible] cumulatively affected by the [illegible] money supply [illegible] quite different [illegible] [illegible] and [illegible] in the 1920's [illegible] are or are not included in the definition of money.

Some of the movements in V will be erratic and relatively unpredictable; others will be in some measure predictable. In particular, although they are operationally hard to identify in the empirical record, there can always be expected certain changes in V that are themselves induced by the change in M itself and, certain other things being held constant, are part and parcel of such a change in M. Some possible [illegible] can be made [illegible] these induced changes in V at various phases of the business cycle and at various time periods in history and it is [illegible]

importance of money substitutes and various concepts of liquidity were to imply that changes of M in one direction can be expected to be followed systematically by opposite changes in V just large enough to offset any resulting induced changes in MV = PQ, then the casual reader of the Radcliffe Report would be right to think that central banks are unable to affect significantly aggregate spending by conventional open-market and lending operations. But none of the testimony or arguments in connection with the Radcliffe Committee succeed, in my judgment, in establishing a presumption in favor of this doctrine of Induced-velocity-changes-that-just-offset-money changes.

b. Not only is this not demonstrated in the historical record, but in addition such a finding is not in accordance with that type of analysis which is thought to have displaced the old Quantity Theory. For, in the various Keynesian models, there is generally a presumption that an increase in M engineered by the central bank will cause such a reduction in interest rates and increase in credit availability as to generate an increase in investment and total spending just large enough to create an extra level of income to absorb in transaction balances the new increment of money created. While the mechanism just described holds for the most primitive Keynesian model, the same conclusion is found to be valid for more sophisticated models, which pay explicit attention to wealth and other stock effects and which distinguish a long chain of assets

that range from being very near to money (like short-term government bonds) to being very illiquid and difficult to sell or evaluate (like built-in machinery that is highly specific to a particular location and owner). And the qualitative nature of the conclusion -- that the central bank can expand spending by expansive open-market, lending, and reserve-rate fixing operations -- will still hold even after we have admitted the existence of relatively-less-controlled financial intermediaries like saving banks, finance companies, insurance companies, mutual or unit-trust funds, and various forms of equity and loan participants. (With his permission, I will refer briefly to an interesting demonstration by Professor James Tobin of Yale in an unpublished manuscript privately circulated several years ago: Suppose that we have a chain of substitutes, which instead of being called tea, coffee and coca are called bank money, short-term bonds, long-term bonds, insurance assets, and so forth; call them M_1, M_2, ... and suppose that their respective prices are N_1, N_2, ... If the central bank could decrease all of the M totals together by operations and fiats that apply to insurance companies as well as to banks and to all financial intermediaries, then no one doubts that the total of "liquidity" however measured would go down and that this would, other things equal, tend to have a depressing effect on aggregate spending and general inflationary pressures. Specifically, with every M_i decreasing because of direct central

bank action, the unweighted or weighted sum of the M's and every other recommended measure of "liquidity" would also go down. But now suppose that the central bank can only decrease directly M_1, having no direct controls on the reserve-ratios or totals of any other sectoral M_i. A reader of the whole of the Radcliffe Report and Hearings might be forgiven for inferring that in this case nothing positive could be said about the ability of the central bank to affect total liquidity, as measured by some kind of total of the M's or weighted-sum of the M's or other measure of liquidity; and hence, that we should abandon the simple notion that a modern central bank can by its conventional operations push aggregate spending in a desired direction. Tobin, however, in his unpublished memo, has shown that provided the M's are all substitutes (in the sense that the excess demand for each M_i decreases when its own N_i price rises but increases when some other M_j's N_j goes up -- as for example that an isolated increase in the price of short-term bonds should cause less of them to be demanded and more of long-term bonds to be substituted for them), then the central bank can cause every M_i to go down by simply depressing M_1 ! (The theorem is like the Leontief one which says that raising the consumption requirements for hats must raise gross output of every good in a well-behaved input-output system, and like the Metzler-Keynes theorem that an increase in domestic investment in one country must to some degree raise outputs everywhere in a well-behaved

[illegible] the assumption of [illegible] and at [illegible]

[illegible] "[illegible]"

[illegible] play no role. But one suspects that the central

bank has been thought to control M_1, [illegible]

[illegible]

central M_1. A reader of the works of the Radcliffe Report and Keynesians might be forgiven for inferring that in this case nothing positive could be said about the ability of the central bank to affect total liquidity, as measured by some kind of total of the M's as weighted [illegible] the Y's or other measure of liquidity and hence, that we should consider the simple notion that a modern central bank can by its [illegible] operations push economic [illegible] in a desired direction. Still, however, [illegible] and other that, provided the M's are all gross substitutes (in the sense that the excess demand for each M_i decreases when its own M_i goes up [illegible] but increases when some other M_j's go up -- as for example that an increase in the price of short-term bonds should cause less of them to be demanded and more of long-term bonds to be substituted for them), then the central bank can cause every M_i to go down by simply depressing M_1! (The theorem is like the Leontief one which says that [illegible] the consumption requirements [illegible] raise gross output of every good in a well-behaved input-output system, and like the Metzler-Mosak theorem that an increase in domestic investment in one country must to some degree raise incomes everywhere in a well-behaved

many-sector multiplier model.) This important Tobin result accords well with intuition. One should not push it beyond its actual statement: each indirect effect is generally speaking, weaker than each direct effect and the central bank may have to push undesirably harder on M_1 to get the same change in over-all M's than it would have to do if it were given direct powers to affect financial intermediaries.* As will become evident later, the case against bills only is not vitiated by the Tobin argument. Later too I shall have to point out some important limiting cases where the potency of central bank action becomes quantitatively zero or almost zero.

9. The asymmetry of monetary policy's effectiveness. It has often been said that monetary policy is more effective in contracting an economy than in getting it to expand. There is an important grain of truth in this observation: thus when Bank Rate or the Discount rate is six or seven per cent and the commercial banks' excess reserves are at a minimum and the business community is heavily dependent upon bank borrowings for its current investments in inventories and other items, then further restrictive

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*This corresponds to a therorem that, in appropriate units $\left|\partial N_i/\partial M_i\right| > \left|\partial N_j/\partial M_i\right| > 0$ for certain systems of Leontief, Metzler, and Mosak-Hicks type, as has been recognized by diverse writers such as Hicks, H. Johnson, Morishima, and others. It does not deny that in certain limiting cases of perfect substitution these effects will be equal, or that in certain limiting cases one or both may be zero.

accelerator multiplier model.) This important [illegible] analysis well worth repeating. One should [illegible] much it beyond its actual statement: each indirect effect, in [illegible] [illegible], rather than [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] then it would have to be if it were given [illegible] [illegible] to affect [illegible] [illegible] [illegible] [illegible] become evident [illegible], the case [illegible] [illegible] [illegible] is not validated by the [illegible] [illegible]. [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] the [illegible] of [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible].

5. [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]. It has [illegible] been said that monetary policy is more [illegible] [illegible] [illegible] [illegible] [illegible] than it [illegible] it is [illegible]. There is an important grain of truth in this observation: [illegible] [illegible], [illegible] rate of the [illegible] [illegible] is six or seven per cent and the commercial banks' excess reserves are at a minimum and the business community is heavily dependent upon bank borrowings for its current investments [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]

[illegible], corresponds to a [illegible] [illegible], or [illegible] [illegible] $\left| \partial M_i / \partial M_j \right| > 0$ for certain systems of Leontief, Metzler, and Mosak's type, as was [illegible] [illegible] by [illegible] writers such as [illegible] [illegible], [illegible], and [illegible]. It does not deny [illegible] [illegible] [illegible] limiting cases of perfect substitution [illegible] [illegible] [illegible] [illegible] [illegible], or that in certain

action by the central bank can by a variety of channels cut deeply into the aggregate of investment and total spending. On the other hand, in a period like the 1930's when the market yield on short-term government securities has already been driven down to a fraction of a fraction of one per cent and when banks have copious excess reserves and business firms are regretting their past investing and regarding the marginal profitability rate on all further investments as negative, there would be little potency indeed in conventional central bank operations: buying short-term bonds in the open market would then merely take from the community a very close money substitute and replace it by money itself, being incapable of having much further depressing influence on the interest rate structure and being incapable of making credit more readily available to borrowers (who are in any case virtually non-existent and automatically regarded as suspiciously risky chaps if they should come forward with a loan application). From the technical fact that monetary policy works more effectively at high than at low interest rates, no one should make the mistake of concluding that the goal of policy should be to avoid low rates. Forks must be made to fit fingers not fingers forks: when an economy will suffer from tight markets and the technician will benefit, it is of course the technician who must properly give way.

a. This last case then is one where an induced change in velocity can be expected

action by the [illegible]

[illegible]

[illegible]. On the other hand, [illegible]

[illegible] yield [illegible]

[illegible]

of a [illegible] one per cent [illegible]

[illegible] reserves and [illegible]

[illegible] investment and [illegible]

[illegible] possibility [illegible] further [illegible]

[illegible] would be little [illegible]

[illegible]

[illegible] open market [illegible]

from the community a very close money substitute and reduce it by means itself, being incapable of having much further decreasing influence on the interest rate structure and other instruments of money credit more readily available to borrowers (who are in any case [illegible] likely [illegible] if they should come forward with a loan application). From the technical fact that monetary policy works more effectively at high than at low interest rates, one should make the mistake of concluding that the goal of policy should be to avoid low rates. [illegible] must be made to [illegible] when the economy will suffer from tight markets and the technician will benefit, it is of course the technician who must properly give way.

[illegible]. This last case then is [illegible] whole [illegible]

[illegible] change in velocity can be expected

to wipe out almost completely any contrived change in money narrowly defined. It is the case often referred to as the Depression-Keynes model, where (1) there is a liquidity trap near to a zero rate of pure interest, at which the Keynesian liquidity preference schedule is practically infinite in elasticity so that the system will absorb great amounts of M at practically the same interest rate and credit-availability, and/or where (2) the rate of investment spending is almost completely inelastic with respect to changes in the interest cost and availability of credit. I believe, in the face of some doubters, that such a depression model has occasional empirical validity -- certainly in the short run and possibly for a vexingly long time. Moreover, bitter experience in the United States of the last few years leads one to suspect that it is not always so easy to engineer a deepening of capital by conventional central bank operations even when one is not in a deep-depression liquidity trap: for, even when gilt-edge rates are lowered farther and farther, the effective profit rates that businessmen must anticipate to get them to make somewhat risky investments may remain quite high -- say 15 per cent before corporate taxes or 8 per cent after taxes - and even massive open-market purchase of government

bonds may not be able to push the system down through a high-profit floor that acts rather like the older Keynes liquidity trap interest floor in keeping investment resistant to expansion.

b. I know it can be argued that the central bank, provided it is ready to abandon notions of feasibility and force the market rates of interest up to 40 per cent in boom times and down to zero, or for that matter down to negative rates of interest, can control the amount of total money and spending activity to any desired levels regardless of adverse fiscal policies and adverse behavior propensities on the part of business and the public. Personally, I consider it irrelevant to talk about 40 per cent bank rates and in any case undesirable to put the burden of such extreme adjustments on the narrow sectors most affected by monetary actions. And as far as forcing extremely low interest rates is concerned, it is simply not true that lending money to people at negative interest rates is guaranteed to result in any desired expansion in spending: making gifts might, but if these are loans that have to be paid back, it would be rational for people to borrow at negative interest rates and just hold the proceeds in safety lock boxes,

thereby earning a handsome yield. The total of something called M might rise, but that does not mean that the requisite MV can be achieved in any short period by conventional central bank operations. My purpose here is not to score a point against some extreme Quantity Theory formulation, but to call attention to the fact that in many social situations a well-running democracy will want its central bank to engage in unconventional activities. (Examples: in the 1930's Federal Reserve Banks made loans directly to certain small businesses; in a future balance of payments crisis the central bank might want to provide certain guarantees and investment insurance to desired domestic investments while keeping up the yields on short-term government bills; and the day could come when the central bank would want to make loans at negative interest rates to applicants who satisfied certain requirements, such as a guaranteeing that the proceeds would go into resource-using investment; if laissez-faire conditions should prove to choke off deepening of capital when profits rates are still as high as 10 per cent and conventional credit operations proved not able to overcome this, the intrinsic logic of central banking requires recourse to new unconventional programs.)

c. Finally, I once felt it necessary to

point out a minor flaw in certain descriptions of the asymmetry of monetary policy's potency. It is not correct to say that monetary policy can contract an economy more easily than it can expand it. In buoyant times when interest rates are already high and credit already tight, monetary policy is very potent <u>both</u> to expand and contract the system from its previous situation; in slack times when interest rates are near the floor and the system is swimming in liquidity, monetary policy is very impotent <u>both</u> to contract or expand the system from its previous level. Thus, the true asymmetry is not that depicted by a corner in the schedule relating general activity and central bank activity, with the slope for an up movement being greatly different from the slope for a down movement; the asymmetry merely refers to the putative difference in slope at any given point in a slack as against a tight credit market.

d. Central Bankers abhor a situation which they feel is not closely responsive to their control. So they naturally dislike being so expansive as to create a "sloppy market." As shown above, the consequences of this abhorrence may not be too costly in the short run; yet they should often brave the displeasure of commercial bankers (who abhor sloppy markets for the good commercial reason that such markets

are hard on bank earnings) and flood the market with a view to the longer-run stimulus in investment that may come from gradual penetration of alleged liquidity-trap floors. One has no right to assume away such longer-run benefits from a policy of "over ease." The central banker will tend to feel that the cost of such a policy will be the danger that in the subsequent recovery period the redundant credit, which had previously done no harm and done precious little good, will come to life and create the possibility of an over-fast expansion and of undue inflationary pressures. This is just another aspect of his reluctance to let the money market get out of his immediate control. While recognizing some merit in this view, I would point out that the goal of policy is not to minimize the unease of central bankers; they are supposed to suffer psychic pain when that is in a good cause. Moreover, some quickening in their contractionary actions early in the recovery may serve to undo much of the harm to be expected from an earlier policy of over ease, and such a quickening would in many cases be a worthwhile price to pay for improving the slump situation. What I am saying here would not be so important if the only thing to fear were a regular cycle involving a recession known to be short lived. But when an economy moves into an epoch when

[illegible]

[illegible] of alleged liquidity-trap limits. One has no right to assume away such longer-run benefits from a policy of "easy money." The central banks [illegible] the goal of [illegible] a policy will be the [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] the [illegible] market get out of the [illegible] [illegible]. While [illegible] some merit in this view, I would point out that the goal of policy is not to minimize the [illegible] of central bankers: they are supposed to suffer psychic pain when that is in a good cause. Moreover, [illegible] in their [illegible] [illegible] in the [illegible] [illegible] [illegible] policy of [illegible] ease, and such a [illegible] would in many cases be a worthwhile gain in any [illegible] improving the [illegible] situation. What I am saying here would not be so important if the [illegible] were a [illegible] cycle involving a recession bound to be short lived, and when an economy moves into an epoch when

profit rates are sluggish (having been competed down by the plentifulness of capital stock relative to labor, and the nature and speed of contemporaneous technical change) and investment is hard to coax out at still lower profit rates, the best policy for conventional central banking operations is to keep the money market flooded with reserves, with a view to eroding gradually resistant long-term interest rates and the profit-rate floors that businessmen insist upon getting if they are to make resource-employing investments. Specifically, in the U.S. environment of the 1930's it was right to have great excess reserves and minimal short-term rates: the slow, too-slow, drop in long-term interest rates was thereby encouraged. With due regard to future international payments considerations, the same strategy will be needed in certain future times; and American central bankers are wrong to reproach themselves for over ease in the 1953-4 and 1957-8 recessions.

e. Zealots for monetary policy are, somewhat pardonably, infuriated by a related asymmetry that used to be argued by critics. These critics would say in one breath, "Monetary action is practically impotent," and in the next breath they would add, "But using monetary policy determinedly will plunge the system into a crisis and major depression." This argument is thought to

profit rates are sluggish (having been competed down by the plentifulness of capital stock relative to labor, and the nature and speed of contemporaneous technical change) and investment is hard to coax out at small lower profit rates, the best policy for conventional central banking operations is to keep the money market flooded with reserves, with a view to eroding downwardly whatever long-term interest rates and the profit rates [illegible] that businessmen [illegible] if they are to make long-term--capital-using investments. Specifically, in the U.S. experience of the 1930's it was right to make great excess reserves and minimal short-term rates. The slow, too-slow, drop in long-term interest rates was thereby encouraged. With due regard to future international payments considerations, the same strategy will be needed in certain future times; and American central bankers are wrong to reproach themselves for over-ease in the 1953-4 and 1957-8 recessions.

2. [illegible] monetary policy are somewhat paradoxically, [illegible] by a relevant asymmetry that used to be stressed by critics. These critics would say in one breath, "Monetary action is practically impotent," and in the next breath they would add, "But wrong monetary policy determinedly will plunge the system into a crisis and major depression." This argument is thought to

involve almost a self-contradiction. How can a thing be simultaneously both weak and strong? Formally, this can be saved from being utter nonsense by modifying it to say, "For a small exercise of monetary policy, the results will be not only small but disappointingly small; for a really large exercise, the results will be disastrously large." To this defenders of the view that M can take care of everything will naturally reply, "Aha then, it is really only a matter of using the right (intermediate) dosage." On the whole I have to agree with this defense of monetary policy, particularly in the historical context of the postwar U.S. debates as to whether letting War Bonds fall below par would entail uncontrollable disaster. But in terms of the logic of all the situations that could possibly arise, two qualifications ought to be made. i) If the response to a control lever satisfies a function that changes suddenly from a low slope to a high one, and at an unknown spot, then a correct dosage is extremely hard to reckon or to work out experimentally; so in some, perhaps rare and unrealistic, situations the asymmetry arguments of the pessimists might have a measure of validity. ii) There is a second complication that may have been envisaged by users of this asymmetry argument, namely the possibility that in certain situations market expectations

[illegible]. The one [illegible] honestly, [illegible] exercise of monetary policy, the results will be not only small but disappointingly small; for a really large exercise, the results will be disastrously large." To this defender of the view that a [illegible] dose of monetary policy will actually imply. And then, it is really only a matter of using the right ("intermediate") dosage." On the whole I have to agree with this defense of monetary policy, particularly in the historical context of the present U.S. debates as to whether [illegible] below [illegible] would [illegible] disorder. But in terms of the logic of all the situations that could possibly arise, two qualifications ought to be made. (i) If the response of a [illegible] changes suddenly from a low value to a high one, and at unknown [illegible], then a correct dosage is extremely hard to ascertain or to work out experimentally; so in sum, perhaps more [illegible] the symmetry argument of the pessimists might have a measure of validity. (ii) There is a second complication that may have been envisaged by users of this symmetry argument, namely the possibility that (i) certain [illegible]

are important with investment demand depending on the bond prices that the central bank engineers and also on the rate of change of prices; given differential equation relationships of the form $F(I,P,dp/dt,M,...)=0$, there could result discontinuities in the solutions. An example would be the case where shovelling a little snow up hill may, at an unknown and quite unpredictable point, set off an avalanche of snow. To say in such a situation, "It is only a question of the right intermediate dosage" is to miss the point.

10. The fallacy that monetary policy controls price levels and fiscal policy controls output levels. It was once widely believed, and some central bank authorities still believe it, that the central bank operates to control money, or M, and that M operates directly to control the price level, P. In the old days the quantity of output, Q, was not thought to need determining by any particular agency, since something like full employment was more or less taken for granted; in more recent decades, holders of the present view have been prone to think of government fiscal policy as somehow having the ability to control Q with monetary policy controlling P. Later I shall deal with proper goals of central banking and shall be critical of the view that price stability has *per se* primacy. The point I want to make here is a purely mechanical one and has nothing to do with

[illegible]

on the bond prices that the central bank engineers and also on the rate of change of [illegible] of the form W(i,t,dr/dt,M,...)=0, there could result different [illegible] in the [illegible]. An example would be the case where [illegible] a little more up hill may, if we [illegible] the quite [illegible] point, set off an avalanche of snow. To say in such a situation, "It is only a question of the right intermediate dosage" is to miss the point.

11. The fallacy that monetary policy controls price levels and [illegible] nominal output levels. It was once widely believed, and some [illegible] still believe it, that the central bank operates to control money, or M, and that M operates directly to control the price level, P. In the old days the quantity of output, Q, was not thought to need determination by any monetary agency, since something like full employment was more or less [illegible]; in more recent [illegible], believers of the present view have been prone to think of government [illegible] as having the ability to control Q with monetary policy controlling P. Later I shall deal with present models of neutral money and shall be critical of the view that price stability can be made primary. The point I want to make here is a purely semantical one and has nothing to do with

subjective value judgments. It is simply untrue that money and credit programs have any way of peculiarly affecting the P or price factor: successful monetary expansion will, as I have shown above, have some favorable effect on the dollar value of total output $P \times Q$ and so will expansionary fiscal policy; the resulting change in $P \times Q$ will get distributed between expansion in Q as against expansion in P, depending upon how much or how little labor and capital remains unused to be drawn on and upon how strong or weak are the cost-push upward pressures that come from the institutional supply conditions of organized and unorganized labor, of oligopolistic price administrators and more perfectly-competitive enterprises. No one has been able to establish any presumption that either monetary policy or fiscal policy has some special impact upon the price as against the output factor. Indeed one cannot too often correct the view widespread among non-economists, that a "natural" upswing in consumption or investment spending is less inflationary than an equivalent upswing in aggregate spending, $P \times Q$, brought about by deliberate public policies. (It is true that one expects a somewhat different mix of expenditure to result from new investment spending induced by credit policy than from new consumption spending induced by tax rate reduction. Likewise a private inventory boom will encounter price rises from bottleneck pressures different from those of a private equipment boom or those of a defense boom. But there is no

[illegible] statement. It is simply untrue that money and credit programs have any war of [illegible] (by a [illegible] price factor). Monetary expansion will, as I have shown above, have some [illegible] effect on the dollar value of total output Y, and so will expansionary fiscal policy. The resulting change in Y will be distributed between expansion in Q and upward movement in P depending upon how much or how little labor and capital [illegible] to be drawn [illegible] upon the strength of [illegible] cost-push demand pressures that come from the [illegible] conditions of organized and unorganized labor, of oligopolistic price administrators and more perfectly-competitive enterprises. No one has been able to establish any presumption that either monetary policy or fiscal policy has some special impact upon the price as against the output figure. Indeed one cannot even offer [illegible] the [illegible] 'dollar' [illegible] non-inflationary [illegible] 'dollar' of spending in consumption or investment spending is less inflationary than an equivalent spending in aggregate spending, [illegible], brought about by alternate public policies. (It is true that one expects a somewhat different mix of expansions to result from new investment spending induced by credit policy than from new consumption spending induced by tax rate reduction. Likewise a private inventory boom will generate [illegible] differential pressures different from those of a private equipment boom or those of a defense boom. But there is no

differential price-level presumption associated in general with deficit, credit, or private stimulation.)

a. I have been careful in all earlier technical notes to state the Quantity Theory of Money in terms of proportionality between M and PXQ, rather than in the older terms of proportionality between M and P. The first of these formulations has the advantage that it allows real output to increase considerably from an underemployment situation without there having to be much price rise up to the time that bottlenecks and resource scarcities appear; it allows also for the occurrence of "sellers' inflation", in which there may be an upward push on prices from the wage, profit, and raw material cost side. Since V and Q both tend to rise with the business cycle, Irving Fisher and older writers thought that the ratio of P to M might be approximately constant; however the facts of the last 40 years do not accord well with such an hypothesis.

b. Facts aside, there is one model or case in which the older Quantity Theory would indeed be true. Imagine a new situation in which <u>every</u> price and every value magnitude has exactly doubled or halved, so that <u>all</u> price ratios and real quantities are absolutely unchanged. The essence of money--be it shells, or gold, or bits of paper and in contrast with drinkable coffee or

[illegible]

general wage policy, prices, or private [illegible].

2. I have very carefully, in all modern [illegible] terms to state the quantity theory of money in terms of proportionality between M and MV, rather than in the older terms of proportionality between M and P. The [illegible] of these [illegible] was the [illegible] that it allows [illegible] to increase [illegible] from an [illegible] without having to be [illegible] up to the [illegible] [illegible] [illegible] the [illegible] of [illegible] [illegible], to which there may be no upward [illegible] [illegible] [illegible] [illegible] the [illegible], Irving Fisher and other [illegible] the ratio of P to M to be approximately constant, however the [illegible] in the [illegible] of money is not as [illegible] well [illegible] [illegible].

3. [illegible] the [illegible] of the [illegible] [illegible] quantity theory [illegible] [illegible] a new [illegible] in which [illegible] [illegible], so that [illegible] prices [illegible] [illegible] absolutely [illegible]. The [illegible] of [illegible], or [illegible] of [illegible] and [illegible] with [illegible]

any good where consumption gives psychic satisfaction--is that we want it only for its ultimate indirect utility in getting goods that can give direct utility. Basically, we want to hold money only in order to be able to spend it some day in exchange for something directly useful. Therefore, when all prices have exactly doubled or halved while all real magnitudes and exchange ratios and interest rates have stayed exactly constant, the desired amount of money holding can be thought of as exactly doubling or halving. In this sense and situation, there is an underlying truth in a strict Quantity Theory that makes P and M exactly proportional. (Technically, economists describe this by saying that all real quantity relations are homogeneous of degree zero in <u>all</u> absolute prices and all value magnitudes like $p_1 \times q_1$ are homogeneous of degree one in terms of all p's; hence the needed amount of money -- the number of wampum beads or ounces of gold or items of paper currency is a homogeneous function of degree one in all the prices when expressed in terms of that unit. Note that whenever a substance used as money also has a direct utility -- as in the case of gold for teeth or of beaver skins for coats -- this strict Quantity Theory no longer applies: double the amount of beaver skins by central bank or other activity and the price of wool will not double even if the price

[illegible]

of mousetraps should.* Note too that this version of a quantity theory would hold even if the real part of the model were different from the classical one involving full employment, as in the case of some of the deep-depression Keynesian models of underemployment where so-called Pigou-effects were deemed not to operate. If the economist stipulates a real model that lacks unique equilibrium, then a change in absolute price levels might jar the system from one admissible equilibrium to another, thereby jeopardizing the "neutrailty" of money.)

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*From this formulation it will be evident that along with the total of any useless M stuff, be it shells or metal or fiat paper money that represent non-interest-bearing I.O.U.'s of the government, we should also take account of any interest bearing I.O.U.'s of the government (which people think of as an asset but fail to think of as involving a personal liability for future taxes). The strict Quantity Theory now says: double fiat M and fiat government bonds and you will exactly double all prices and values in a classical model that has all its real magnitudes and relative prices unchanged. These fiat bonds are important without regard to the fact that they are useable directly for exchanges or are close money substitutes. As will be seen shortly, some conventional credit operations that involve the same change in M will differ markedly in their "Pigou effects" and potency, a fact ignored by simple-minded theorists.

of [illegible] goods [illegible]. Note too that this version of the quantity theory would hold even if the real part of the economy were [illegible] some of the [illegible] [illegible] theory.

From this formulation it will be evident that along with the level of any [illegible] of that paper money that [illegible] non-interest-bearing [illegible] of the government. [illegible] interest bearing [illegible] of the government [illegible] to treat [illegible] taxes). The [illegible] government bonds and [illegible] will [illegible] in a [illegible] and relative prices unchanged. These [illegible] are [illegible] the fact that they are [illegible] of the [illegible] money [illegible]. As will be seen shortly, some conventional [illegible] operations that involve the same change in M will [illegible] in their 'Pigou effects' and [illegible] a [illegible] by a [illegible]-minded theorist.

b. Simple models do great good in clarifying issues. They can also do great harm if carelessly applied to real life in all its complexity. History does not record nicely balanced changes in all prices that are as neutral with respect to real effects as would be a dimensional transformation in which one chooses to reckon in terms of cents rather than dollars or in terms of dozens of eggs rather than single ones. And what is more relevant, when the central bank increases one or another measure of the money supply by 10 per cent, this will not, and cannot, result in a nicely balanced change in all prices and values. It literally cannot do so because all past contracts and past prices are already determined: as a debtor your real position is altered by this new change in M, just as my position as a creditor is altered. Nor is there the slightest guarantee that what I gain you will lose, since there is no law of conservation of total well-being under such a change. Indeed, since the time of David Hume it has been generally thought that mild <u>unexpected</u> price rises tend to expand the degree of utilization of resources and to channel resources into the hands of the more active entrepreneurial elements at the expense of more inert classes. During periods of mild or severe inflations certain <u>changes in relative prices</u> have been considered to be characteristic.

c. While the conditions for a strict Quantity

Theory to be valid or unrealistic, they probably become somewhat less so in the long run. I suspect that after more research has been done we shall learn that many of the systematic changes in relative prices induced by transitional inflations are not so great as has been believed; for, it seems odd that continuing price rises should keep coming as a surprise to people. Moreover, the longer the run the less important will be the effects of past contracts and remembrance of lower levels of past prices. The past is, one supposes, as long as the future. But well-behaved and stable price systems tend to have the property of gradually "forgetting" the past. If that were not so, the way that the War of the Roses was financed would be as important for 1962 behavior as the sliding-scale wage contracts of 1961. So a once-and-for-all doubling of money will eventually imply that the distortion inherent in the fact that past prices certainly have not doubled will become less and less relevant. The simpler minded Quantity Theory is thus seen to have its greatest measure of empirical validity in the longest run. Having emphasized this kernel of truth, I must quickly add the warning that it is precisely in the long run that other things will not have remained equal: exogenous and endogenous shifts in the relations determining equilibrium will certainly have taken place, thereby vitiating any simple price-scale change as an interpretation of the empirical facts.

[illegible]

learn that many of the systems' [illegible] in relative prices induced by [illegible] inflation are not so great as has been believed. [illegible] it seems odd that continuing price rises should come as a surprise to people. Moreover, the longer the run the less important will be the effects of past contracts and remembrance of lower levels of past prices. The past is, one supposes, as long as the future. But well-behaved and stable price systems tend to have the property of gradually "forgetting" the past. If that were not so, the way that the War of the Roses was financed would be as important for [illegible] behavior as the sliding-scale wage contracts of [illegible]. So a once-and-for-all doubling of money will eventually imply that the distortion inherent in the fact that past prices certainly have not doubled will become less and less relevant. The [illegible] Quantity Theory is thus seen to have its greatest measure of empirical validity in the longest run. Having emphasized this kernel of truth, I must quickly add the warning that it is precisely in the long run that other things will not have remained equal: exogenous and endogenous shifts in the relations determining equilibrium will certainly have taken place, thereby vitiating any simple price-scale [illegible] as an interpretation of the empirical facts.

Even if one could rule out purely exogenous disturbances, real economic life does not consist of a return to the same pre-determined real equilibrium after a transient change in money supply. I live but once and if an inflation wipes out my real net worth that is an irreversible fact. The distribution of income and corporate power was never (including the position of Hugo Stinnes) quite the same after the 1920-23 German inflation: even if a Lorenz curve depicting the inequality of distribution of income or wealth begins to revert toward its earlier form, the class ownership of wealth could be permanently different. Even the same Lorenz curve will not imply the same people in the background and the same behavior propensities. Capitalism, as we know it today, would have probably been systematically different if Columbus had never discovered the New World with its vast areas of gold and silver. All that I have just been saying is rather hypothetical. But there can be no doubt that if Canada and the United States had followed policies which prevented the Great Depression of the 1930's, today in 1962 we would have an entirely different stock of capital goods. And it is wrong to argue that this means merely that we arrive in 1962 at the state we would have otherwise reached in 1952 or 1945: to have arrived at our present "capital abundance" prior to knowing the discoveries of <u>recent</u> science would imply a qualitatively and quantitatively different pattern of economic history.

[illegible]

[illegible] discovered the New World with its vast stores of gold and silver. All that I have just been saying is rather hypothetical. [illegible]

[illegible] "capital accumulation" [illegible]

(Technically, the theorist describes all this by saying that every economic equilibrium displays important hysteresis effects, where the very location of the equilibrium position depends upon the actual historical path of the system and thus there can never be truly neutral changes in the absolute price level. As a craftsman, I could wish that reality corresponded to the mechanics of a system without hysteresis because this would make my task of analysing economic reality so much more pleasant and simple. But just as the purpose of evolution has not been to give central bankers an easy life, neither has it been to give theorists restful nights and plenty of time to play golf or chess. While my examples have been primarily taken from price rises, the hysteresis effects from price declines are greater still because of price and wage rigidities which persist even in the long run. The attempt after World War I to roll back the price rises by reverting to 1913 gold parities has aptly been compared to the act of running over a man and then backing up over him a second time to undo the first effects. The corpse would recognize hysteresis effects even if many of the best economists of that day did not. All this may seem abstract and admittedly it is expressed in technical language. Yet it does have fundamental economic implications. Simple believers in M as the determinant of total effective demand do not feel the need to distinguish between, say,

[illegible]

[illegible] effects, [illegible] of the [illegible] [illegible] there can never be truly neutral changes in the absolute price level. As a [illegible], I would wish that reality corresponded to the mechanics of a system without hysteresis because this would make my task of analyzing economic reality so much more pleasant and simple. But just as the purpose of evolution has not been to give mankind [illegible] an easy life, neither has it been to give theorists neutral effects and plenty of time to play golf or chess. While my examples have been primarily taken from price rises, the hysteresis effects from price declines are greater still because of price and wage rigidities which persist even in the long run. The attempt after World War I to roll back the price rises by reverting to 1913 gold parities has aptly been compared to the act of running over a man and then backing up over him a second time to undo the first effects. The corpse would recognize hysteresis effects even if many of the best economists of that day did not. All this may seem abstract and certainly it is expressed in technical language. Yet it does have fundamental economic implications. Simple believers in M as the determinant of total effective demand do [illegible]

an increase in M that comes from the Treasury's (or central bank's) printing new dollar bills and i) sending them to all family heads, or ii) lending them at interest to investors, or iii) spending them on subsidies to investors, or iv) buying back Treasury Bills with them. The same increase in M leads, they allege, to the same change in P$\times$Q (and by strict "homogeneity" reasoning to the same real magnitudes). This is of course patent nonsense in the short run, as they concede when challenged: Under i) consumption is presumably stimulated and interest rates, if anything raised; under ii) interest rate falls, and presumably V too, depending upon how much Investment rises. Only in the longest run, if then, can one assume that the new M gets distributed "ergodically" (i.e., independently of its original point of entry): I say, if then, because at best the stock of capital is permanently different. Note that iv) is without direct Pigou effects and hence presumably permanently different.

d. Gustav Cassel's famous purchasing-power-parity theory of war-dislocated foreign exchange rates was, prior to its reformulation by Keynes and others as a mere condition of spatial price equilibrium, based originally upon precisely the homogeneity assumption I have just described. It could be applied precisely only to balanced inflation such as never took place around the time of World War I.

[illegible] increase in M [illegible] from the Treasury [illegible]

(or central banks) printing new dollar bills and (i) sending them to all family heads, or (ii) lending them at [illegible] interest, or [illegible] them as subsidies to investors, or (iii) buying back Treasury bills with them. The same increase in M leads, they allege, to the same change in the [illegible] current "aggregate" pertaining to the same real magnitudes. This is of course patent nonsense in the short run, as they concede when challenged. Under (i) consumption is presumably [illegible] and interest rates, if anything, raised; under (ii) interest rate lower, and presumably [illegible], depending upon how much investment plans [illegible]. Only in the longest run, if then, can one assume that the new M gets distributed "equitably" (i.e., independently of its original point of entry). I say, if then, because at best the speed of [illegible] is permanently different. Note that (iv) is without direct Pigou effects and hence presumably permanently different.

4. [illegible] theory of war-disbalanced foreign exchange rates was, prior to its reformulation by Keynes and others as a mere condition of spatial price equilibrium, [illegible] assumption I have just described. It could be applied precisely only to balanced inflation such as never took place around the time of World War I.

As a matter of fact in such an hypothetical balanced inflation resulting from a mere change in the absolute amount of an essentially neutral money, we would not get any predictive power from the purchasing-power-parity formulation since in such a world of perfect flexibility the exchange rates would already be at their equilibrium; but to this Cassel would no doubt reply that his theory would have predictive powers in cases where there are only short-term transient departures from balanced inflation and deflation, and during such times his theory would point to the longer-run equilibrium. Eclectic defenders of the usefulness of the reasoning that underlies the strict Quantity Theory and purchasing-power-parity doctrines will gladly jettison the notion that a trillion-fold increase in 1920 German Marks will result in an exactly trillion-fold change in domestic prices and foreign exchange rates: it is enough for their purpose, and mine, to stress that such massive changes in M and related magnitudes will inevitably be associated with massive changes in price levels; and that such massive changes in price levels cannot take place if the total of currency, bank deposits, and related magnitudes are kept fairly constant.

11. Timing and dynamic lags. The effects of monetary policy are not instantaneous. This is not surprising since there are no effects in nature that

is a matter of fact in such an hypothetical universe in which [illegible] resulting from a mere change in the [illegible] amount of an arbitrarily created money, we would not get any predictive power from the current-price-and-money-quantity formulation since in such a world of perfect flexibility the economy would always already be at their equilibrium: and so that Fisher would no doubt imply that his theory would have predictive powers in cases where there are major [illegible] changes from [illegible], and during such times his theory would point to the long-run equilibrium. Specific statements of the predictions of the reasoning that underlies the modern quantity theory and monetarist-guided policy doctrines will gladly [illegible] the notion that a [illegible] increase in the money stock will result in an exactly [illegible] change in domestic prices and foreign exchange rates. It is enough for their purposes, and mine, to stress that such massive changes in M and related magnitudes will inevitably be associated with massive changes in price levels; and that such massive changes in price levels cannot take place if the volume of [illegible], bank deposits, and [illegible] are kept fairly constant.

II Timing and [illegible] lags. The effects of monetary policy are not instantaneous. This is not surprising since there are no effects in nature that

are secured instantaneously. Even when I turn my key in the lock, the fact that there are no perfectly rigid metals means that a slight twisting and delay is inevitably involved. But the intrinsic delays involved in effectuating monetary policy are much longer than this. It is widely believed that monetary policy delays are considerably less than those involved in fiscal policy actions -- such as public works. And this is considered to be one of the great advantages of monetary policy. Actually, though, not a great deal is known in this area and the empirical researches performed so far are only a beginning. (I found it interesting that Lord Cobbold of the Bank of England in his testimony to you referred to his experience of a six-months lag in monetary policy.) In commenting on the interractions between fiscal and monetary policy I shall later have more to say on these problems of timing. In completing the present section on the general properties of monetary policy, I merely want to point out that the inevitable lags both underscore the lack of perfection to be expected from monetary control and condition the procedures to be followed in making optimal decisions. If monetary policy acted almost instantaneously and were subject to easy cancellations,* the central

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*This inability to cancel out previous action without delay is the one valid argument, which I referred to in an earlier section, for not relying on the flooding of the money market in time of presumably short recession; note, though, the need to be able to forecast correctly the shortness of the recession.

be managed responsibly. This does I think go far to the heart of the issue that forms the background of claims during recent years that a crisis is worrying and needs an additional analysis. But the monetary delays involved in forecasting monetary policy are more likely than this. It is widely believed that monetary policy delays are inherently longer than those involved in fiscal policy actions -- such as public works -- and this is considered to be one of the great advantages of monetary policy. Actually, though, not a great deal is known in this area and the empirical evidence put forward so far is only a beginning. I found it interesting that Lord Cobbold of the Bank of England in his testimony to you referred to the experience of a six-months lag in monetary policy. In connection with the interrelations between fiscal and monetary policy I shall later have more to say on these problems of timing. In considering the present emphasis on the general properties of monetary policy, I merely want to point out that the increasingly long lags substitute the [illegible] of performance to be expected from monetary control and condition the performance of the [illegible] in making monetary decisions. If monetary policy moves almost instantaneously and were subject to easy calculations,* the general

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*This flexibility to cancel out previous action without delay is the one valid argument, which I referred to in an earlier section, for not relying on the flexibility of the money market in time of emergency alone. monetary tools, though, the need to be able to

bank would find its task a much easier one: thus it might not have to take anticipatory action prior to a turn down of business activity from a full-employment level; for many purposes it would be sufficient to recognize a turn after it had already happened, which would be a procedure relatively immune from the false forecasts of turns which always plague practical forecasters. But once we recognize that lags of some considerable number of months are involved in securing the effect of new actions, there may be grave harm in a policy which tries to offset a new movement only after enough months have passed to make the direction of that movement terribly obvious. "Don't try to look over hills or beyond valleys," is the sage advice often given by those leary of our ability to forecast. This can be very bad advice, and in fact one has to be very arrogant concerning his understanding of the exact degree of a government's ability to forecast to be able to set down this rule or any other specific rule concerning the sluggishness with which an adapting mechanism is to adjust and react to the information input available. If an airplane follows a relatively smooth path with moderate random errors superimposed on it, the electrical engineer knows he should set up a target computer which is based on considerable extrapolation of previous trajectory; if the statistical properties to be expected of the airplane are quite different -- for example involving almost completely random and unpredictable movements -- the optimal servo-mechanism

[illegible]

[illegible]

[illegible]

level; for many purposes it would be sufficient to recognize a unit after it had a small frequency, which would be a procedure [illegible] from the [illegible] attempts of [illegible] which always [illegible] standard [illegible]. For once we recognize that [illegible] of some considerable number of [illegible] are involved in [illegible] the effect of new activities, there may be great [illegible] process, which tends to affect a new movement [illegible] from [illegible] the [illegible] of that movement. [illegible] the same [illegible] themselves. This can be very bad advice, and in fact one has to be very [illegible] concerning the [illegible] of any small degree of a government's ability or interest to be able to set down this rule or any other specific rule concerning the [illegible] with which [illegible] it to adjust [illegible] input [illegible]. [illegible] follows a [illegible] path with [illegible], the [illegible] should set it [illegible] which is based on considerable extrapolation of previous trajectory; if the statistical properties of the [illegible] of the [illegible] are quite different -- for example, involving almost completely random and unpredictable movement, -- the optimal setting [illegible]

should be a much more sluggish one. So, few a priori rules can be stipulated in advance and certainly none by those who profess to be nihilistic about man's ability to forecast at all. We must get the best guidance possible from experience itself; and I'm quite sure that economic historians will feel that the Federal Reserve system was not premature in taking anticipatory action to ease the money market in the Spring of 1960, which was prior to the May turning point and which definitely involved looking over hills and not waiting to find out exactly which way the wind was blowing in order to lean against it. It is precisely the consideration that optimal stabilization policy must vary with the probability pattern to be expected from the system that needs to be stabilized which makes it rather ridiculous to specify in advance and for all times that some particular gadget like three-per-cent-money-increase-per-year should be adhered to in season and out of season. Were the cold war suddenly to end imagine the avoidable evil consequences that would follow from such a predetermined policy.

II. Goals and Functions of Central Banking and Monetary Policy.

12. Evolution away from profit motive. Anyone who has studied carefully the evolution of Central Banking will have noted the steady broadening of its functions and goals. In the beginning most central banks were hardly distinguishable from a commercial

bank, being first among equals and merely endowed with certain special privileges and duties. Long-run profit maximization was their proper criterion of action. Gradually the profit motive became subordinate, and today it should be of no consequence at all. (The various money creation privileges given by the government to the central bank usually have implied more than enough profits anyway; and in a modern economy the accumulated earnings beyond a nominal minimum must be thought of as reverting, eventually or continuously, to the government -- and note that I did not write the Treasury since that is merely an administrative subdivision.) Profit maximizing is at least a definite task and its disappearance makes the job of decision-making all the more ambiguous and difficult.

13. Multiplicity of goals. After central banks had been recognized as quasi-public institutions, there continued to be an evolutionary broadening of their functions and goals. And I ought to say at the beginning that these purely factual trends are regarded by most economic experts as desirable developments. The same cannot always be said about the attitude of bankers. And even central bankers are not to be regarded as reliable authorities on the proper role of the modern central bank. Governor Strong of the New York Federal Reserve Bank and Montagu Norman of the Bank of England agreed on many things; from beyond the grave they undoubtedly would

disapprove of most changes in central banking which are not even matters of controversy today. If Canada appoints another Royal Commission to look into this matter 25 years from now, the witnesses before it will take for granted many changes that would shock the present generation of central bankers. I suspect that the direction of many such changes can be fairly confidently predicted today. I should add that these developments impress me as being for the most part salutary moves in the battle to improve the performance of non-totalitarian mixed-enterprise systems. Nor are they unique to central banking and monetary policy. If it were once true -- and the evidence for this is remarkably skimpy -- that taxation was never properly to be used for any purpose other than the raising of revenue, one has only to look around at the modern world to realize how untrue this is now and how much would be sacrificed in an attempt to revert back to some hypothetical earlier regime. I should also emphasize that many of the paths of future development are not easily foreseen now, and that the evolutionary process does not move smoothly toward any inevitable goal of perfection. We proceed by trial and error and many entrenched developments can be looked upon as grave mistakes from the standpoint of social efficiency.

14. <u>The primary goals of best utilization of resources on the outputs that are best distributed among people at each time and among present and future uses</u>. Monetary policy, both as handled by the central

bank itself and by the Government, does not have different ultimate goals from fiscal or any other social policy involving economic aggregates. Thus fiscal policy should aim at the proper degree of price stability in comparison with other major goals just as much as should monetary policy. And debt management, if it happens to be in the hands of the Treasury, should no more aim at unduly low interest rates, in order to cater to the vanity of the ruling Chancellor or in order to keep down unduly the tax burden of servicing the debt, than should central bank policies. It is amazing how such a simple truth should be lost sight of in the usual discussions of these matters, including I make bold to say, some of the testimony offered you by eminent witnesses. I consider myself the simple child of the Hans Christian Anderson fairy tale who blurted out the secret that the King was wearing no garments at all, fine or otherwise. In a properly running democracy of the modern mixed-enterprise kind, the ultimate goals of macroeconomics are simply

(i) that there be best utilization of resources, in the sense of no chronic pools of human and property resources that are involuntarily out of work for reasons connected with the level of total dollar spending, and

(ii) that these resources be efficiently combined at producing the kinds of goods that the various citizens really want and need (which rules out as optimal various made-work activity like building

unattractive pyramids or digging holes to be later refilled...), and

(iii) that there be what society, within the framework of its agreed-upon system of property rights, deems to be an appropriate division of command over resources among different age and social classes (which means that society is to have the minimum standards of life provided for various people in accordance with its constitutionally-expressed decisions), and

(iv) that there be the appropriate allocations of current resources between production of goods for present consumption as against goods that involve capital formation and widen the opportunities for future consumption.

All these decisions are made by the people of the democracy both in their individual capacities as spenders of their personal incomes on consumption goods and saving instruments and as spenders of various business funds as owners or agents of owners of property, and in their citizenry capacities as electors of responsible representative government to take care of the cooperative and coordinating functions of economic life and any welfare activities of responsible representative government. It is of course not the function of the Governor of the central bank to impose his own or any one else's opinions on society, any more than it is the function of the Under-secretary of the Treasury or the Secretary or the Budget Bureau Director or the Chief Executive

[illegible] possible [illegible] [illegible] to [illegible]

[illegible], and

(iii) [illegible]

[illegible] of the [illegible] of [illegible]

[illegible]

[illegible]

[illegible] means that society is to have the ultimate elements of life provided for various groups in accordance with its own [illegible] as [illegible] individual), and

(iv) that there be the appropriate allocation as [illegible] between production of goods for present consumption as against goods that involve capital formation and [illegible] the opportunities for future consumption.

All these decisions are made by the people of the community both in their individual capacities as members of their economic [illegible] as consumers of goods and savings [illegible] and as members of [illegible] in control of agents of [illegible] of property, and in their [illegible] capacities as [illegible] of responsible representative government to take care of the cooperative and coordinating functions of economic life and any welfare activities of responsible representative government. It is not [illegible] the function of the Governor of the [illegible] to impose his own or any one else's opinions on society, any more than it is the function of the Under Secretary of the Treasury or the Secretary or the Budget Bureau Director or the Chief Executive

or particular Members of Parliament to do so. But since it is a fact of life, quite unavoidable, that the way central banking and fiscal policy interact has substantive effects on unemployment and the distribution of income among persons and among present and future time periods, it follows inescapably that such considerations as these must have an appropriate role in the decision-making of monetary policy as well as fiscal policy.

15. The vital distinction between means and ends. What about the important goal of "price stability?" What about "exchange rate stability?" What about economic growth? Of course such problems are not overlooked. But it is useful to point out that we want price stability because that may be necessary to keep the aged from being cheated by inflation, or may be necessary to permit efficient business planning and long-term contract formation, or may be necessary to avoid unsettling exchange rate depreciations, and so forth. Put this way, we do not prejudge the question of just what sacrifices have to be made in order to achieve this or that degree of price stability, or even this or that degree of secular price decline or rise. I shall say a great deal more about the problem of price stability, and a little bit about the merits for a country like Canada of various foreign exchange rate policies. I need only here mention that the problem of growth has already been included in my statement of primary goals or

or particular Members of Parliament to do so. But since it is a fact of life, quite unavoidably, that the way central banking and fiscal policy turn out has substantial effects on employment and the distribution of income among present and future persons and between large groups, it follows inescapably that such considerations [illegible] play their part in a significant role in the decision-making of monetary policy as well as fiscal policy.

4. The [illegible]

What about the important goal of "price stability"? What about "exchange rate stability"? What about economic growth? Of course each problem has its own complexities. But it is useful to point out that as much price stability as might be necessary to keep the lid from being blown off by inflation, or as may be necessary to permit efficient business planning and long-term contract formation, or may be necessary to avoid unsettling exchange rate speculation, and so forth. But that way, we do not prejudge the question of just what conditions have to be made in order to achieve this or that degree of price stability or even this or that degree of secular price decline or rise. I shall say a great deal more about the problem of price stability, and a little bit about the merits for a country like Canada of various foreign exchange rate policies. I need only here mention that the problem of growth has already been included in my statement of primary goals or

objectives, since the formulation in the previous section included the problem of achieving the desired allocation of goods between present and future. Since money and credit policies, almost by definition, involve decisions about interest rates and capital availability, which are the key terms of trade between present and future goods, one would have thought that out of any 10 witnesses before a Royal Commission on Money and Finance, almost all would have given a pivotal role to the central bank in helping a democratic society achieve its best feasible growth rate. Yet it is an empirical fact that many central bankers would, at first inquiry, be inclined to deny that growth was at all within their province of preoccupation. It will be clear that I, along with a great number of modern economists, am unable to concur in this view.

16. Monetary policy and stocks as against fiscal policy and flows. "Surely everybody cannot worry about everything and there must be some division of labor in a pluralistic society between various public agencies. If the central and monetary policy tries to do everything, it may end up accomplishing nothing. Whereas if it sticks to a narrow category objectives it will end up contributing, along with other agencies in the division of labor that characterizes modern society, its maximum to the broad objectives of society." Something like this will be argued against my previous remarks, and more still. "What after all is the distinction between monetary policy and any other kind of policy?

The answer to this must be given, and after it has been it will be recognized that it is outside the field of central banking and monetary policy that most of these broad social objectives must be realized." These are all legitimate questions and I now propose to give a tentative answer to the last one. Monetary policy differs from fiscal policy in that it is primarily concentrated with <u>stocks</u> of assets -- like cash, or short-term bonds, or long-term bonds, or borrowings, or various near-moneys and less-liquid net worth items; whereas fiscal policy is more involved with current <u>flows</u> of income -- like tax receipts levied against current income and sales or like current resource-using government expenditures or current welfare-transfer government expenditures. This contrast between stocks and flows as the key element in defining the realm of monetary policy will help to make clear why President Holtrop of the Netherlands Bank insisted in his Testimony before you that whenever debt management is being conducted by the Treasury rather than the central bank, one must recognize that an essential part of <u>monetary</u> (or just as accurately, <u>asset</u>) policy is being controlled outside the central bank. Thus, monetary policy is not that which central banks do and ought to do; nor is what central banks do and ought to do, monetary policy. Monetary policy is asset policy wherever it takes place, and in various times and institutional set-ups will be divided in various ways by organization. One can even imagine and observe, if not recommend,institutional cases where more than

one agency in a country has been exercising central banking functions. And I fear that adherence by those individuals who have been historically identified as central bankers to a narrow definition of their function will simply cause there to grow up elsewhere in society just those activities which they deplore. Before giving an opinion about the useful relationship between central bank and government, I want first to give a caricature of certain views about what constitutes central banking. While this is avowedly a caricature it cuts too close to the bone for comfort.

12. A caricature of what a central bank should be. Against the above viewpoints, here is another. The job of a central bank is to guard the stability of the price level. It controls money and every school boy knows that money is what determines price levels. It never interferes with or affects relative prices or the sectors in which activity takes place. It leaves all that to the free market place: for the reason that a belief in freedom requires this; and for the reason that this is a more efficient way for society to organize itself. Democracy, and government generally, is always biassed in the direction of producing inflation. This is the great evil against which the central bank must always take guard. Because democracy can never be trusted, the central bank must be set up as an insulated non-political bastion of price stability, responsible to no one in the community but only to its function. It must therefore

the agency in a country has been exercising central banking functions. And I can [illegible] by [illegible] individuals who have been [illegible] central banker to a narrow [illegible] of [illegible]. [illegible] could [illegible] to grow as [illegible] in society just those activities which [illegible] [illegible] the [illegible] relationship between central bank and government. I [illegible] a [illegible] [illegible].

[illegible]

[illegible] against the [illegible], [illegible] in [illegible]. The job of a central bank is to [illegible] the stability of the price level. It [illegible] money and every [illegible] that money is [illegible] price level. It never interferes with [illegible] or [illegible] in the [illegible] in which activity takes place. It [illegible] all that [illegible] goods [illegible] reason that a [illegible] requires [illegible] and the reason that this is a [illegible] way for society to organize itself. Democracy, and government generally, is always biassed in the direction of generating inflation. This is the point with respect to which the central bank must always be on guard. Therefore democracy can never be trusted, the central bank must be set up as an insulated non-political bastion of price stability, responsible to no one in the community but only to its function. It must [illegible]

issue public statements of warning against public excesses. It must refuse to finance government deficits, and particularly must never finance them by issue of notes or by purchase of short-term floating debt. It should rarely even take on the long-term debt of the government. When a particular gang in office are behaving particularly badly from the standpoint of fiscal soundness, it is the duty of the central bank to contrive or help a flight away from the currency, calling upon central bank cousins abroad who act according to the motto approved by Professor T. Gregory, "Who hurts one, hurts all." It is a lonely and unpopular life, redeemed only by a good cuisine and a sense of righteousness at a distasteful task performed well. Secrecy is all important. The wisdom of private bankers, who understand these issues and are less inflationary minded than the community generally, should constantly be sought. Balance of payments problems, which domestic wastrels look upon as a necessary evil, the central banker regards as a blessing not in disguise: it enforces the discipline so shockingly absent in these parlous times. Career men, who begin life not overly burdened with academic knowledge, make the best successors to similar chiefs; but a few sound academics are useful too, not for helping to run day-to-day affairs -- since outside help for that is to be found in men who know and make their money from the money market -- so much as for providing general ideological defenses for the beneficent institution. Central bank employees are

like ballerinas who must practise each day; you must never let them go off on tours of duty in other branches -- scratch out the word "other" -- of the government, for that will blunt their abilities. Moreover, they are pure-bred ballerinas and you must not introduce into the central bank barnyard outside government officials, even on temporary tours of duty, for their contact with the ballerinas may involve a certain contamination that will be detrimental to proper performance. There is no point in prolonging such a cruel caricature. Like most caricatures it does serve the purpose of portraying in an exaggerated way some not uncommon attitudes. Moreover, although I have called it cruel, there are some writers, fewer today than in the past, who would claim literally that a central bank ought to be secretive and lean over backward as the only watch dog of the stability of prices in a world where all other interests seem biassed toward inflation. A more moderate and defensible position would frankly assert that the monetary authorities should overstate their case so that in an adversary procedure a better balance between inflation and deflation would be achieved. I think it interesting for example that President Holtrop in his testimony attached prime importance to the stability of the internal and external value of the currency. And Lord Cobbold, in his image of the automobile, instinctively thought of the central banker as the one who kept his foot on the brake while others pumped against the accelerator. On an <u>a priori</u> basis a lack of coordination between the government

[illegible]

[illegible] for that will [illegible] their abilities. Moreover, they are [illegible] and you must not interpret the [illegible] government [illegible] or temporary forms of [illegible], for their [illegible] with the [illegible] may involve a certain [illegible] that will be [illegible] to proper performance. There is no point in prolonging such a cruel caricature. Like most caricatures it does serve the purpose of portraying in an exaggerated way some not uncommon attitudes. Moreover, although I have called it cruel, there are some who would, fewer today than in the past, who would [illegible] literally want a central bank [illegible] to be [illegible] and [illegible] as the only [illegible] of the stability of prices in a world where all other instruments [illegible] toward inflation. A more moderate and [illegible] position would frankly admit [illegible] [illegible] in an [illegible] governing a [illegible] between inflation and [illegible] would be [illegible].

I think it [illegible] that [illegible] in his testimony [illegible] prime importance to the stability of the internal and external value of the currency. And Lord [illegible], in his [illegible] the [illegible], instinctively thought of the central banker as the one who [illegible] his foot on the brake while others pumped against the accelerator. On an [illegible] basis a lack of coordination between the government

and the bank could involve an interchange of positions half the time; but that is not the way things seem to modern central bankers. (Later in discussing growth I shall have to make the point that this kind of lack of coordination between central bank and government is a powerful drag on growth because it uses a lessening of capital formation as the offset to overspending on private and collective consumption.)

18. The optimal long-term pattern for prices. There are three interesting possibilities for the trend of average prices: steadily and slowly downward; steadily and slowly upward; essentially level. Which of these three patterns is best? This is a difficult and perhaps even meaningless question to ask if nothing is specified about the uncertainties and errors of foresight that are supposed to accompany each pattern. However, certain normative evaluations can be made if we are willing to consider the rigorously abstract model where uncertainties and errors of foresight are absent. I fear that an unwary reader of the testimony presented to you by my long-time friend Sir Dennis Robertson may form an incorrect opinion on this subject. If I understand Sir Dennis he argues that, feasibility aside, it is a more proper pattern to have prices slowly falling with the increase in technological productivity so that the fruits of technological progress are distributed even-handedly among workers, property owners, retired persons, and so forth. Feasibility aside, is this a correct finding of economic

and the [illegible] decline as consequence of population [illegible] time; but that is not the way things seem to modern central bankers. (Later in discussing growth I shall have to make the point that this kind of [illegible] [illegible] growth, because it is a [illegible] of [illegible] as the [illegible] private and collective consumption.)

VI. The [illegible]. There are three [illegible] possibilities for the [illegible] of [illegible] and [illegible], [illegible] levels. Which of these [illegible] is best? This is a difficult and [illegible] question to [illegible] making [illegible] and [illegible] the [illegible] and [illegible] of [illegible] that are [illegible] to accompany each pattern. However, [illegible] normative evaluations can be made if we are willing to consider the extremely abstract [illegible] and [illegible] of foresight [illegible]. I [illegible] the [illegible] of the [illegible] presented to you by my long-time friend Sir Dennis [illegible] opinion on this subject. If I understand [illegible] that, feasibility aside, [illegible] pattern to [illegible] with [illegible] in technological [illegible] so that the fruits of technological progress are distributed even-handedly among workers, property owners, retired persons, and so forth. Feasibility aside, it was a correct finding of economic

theory as was argued by many economists in the 1930's? I think not. A world in which there is and has been and will always be a positive exponential rate of rise in absolute prices would have <u>exactly the same real allocations</u> among labor and non-labor factors of production and among young and old as would a world with a foreseeable exponential fall in prices, or a world with stable prices. Indeed as Thornton, Marshall, Wicksell, Fisher, and others have argued there tends to get built into the money rate of interest a full allowance for the foreseeable change in price levels; and my study of the interest rates that insurance companies and others pay on fixed-money contracts suggests to me that something like this has already happened in some degree in America and abroad. I conclude from this that there is no presumption in the purest theoretical model in favor of the view that a slowly-declining price level is optimal.

a. The criterion that the ideal situation is that which would correspond best to an idealized state of barter, where money has no so-called distorting effects and is allegedly "neutral," strikes me as a rather gratuitous criterion. It completely ignores the fact that one has to have an agreed-upon social welfare function that adjudicates the deservingness of those who gain from price change before any real normative statements can be made. But sticking to that criterion, I hope I have shown that within the abstract model involving no rigidities and uncertainties, the Robertson

income is not subject to real diminution by the effect of

I think not. A world in which there is and has been and will always be a positive compensating rate of price [illegible] absolute prices would have greatly the same real allocation among labor and capitalists, "workers" and [illegible] then and [illegible], young and old as would a world with [illegible] expectation [illegible] price [illegible] stable prices. [illegible] as [illegible] Hicks, [illegible] Fisher, and others have argued there tends to get built into the money rate of interest a [illegible] allowance for the foreseeable change in price levels, and my study of the interest rates that insurance companies and others pay on fixed-money contracts suggests [illegible] [illegible], something like this has already happened to some degree in America and abroad. I conclude from this that there is no presumption in the purest theoretical model in favor of the view that a steadily declining price level is optimal:

1. The criterion that the [illegible] situation is that which would correspond best to an idealized world of barter, where money had no so-called distributive effects and is allegedly "neutral," strikes me as a rather peculiar criterion. To completely [illegible] that, one has to [illegible] upon social welfare functions that minimize the [illegible] of those who gain from price changes before any real normative statements can be made. But sticking to that criterion, I hope I have shown that within the abstract model involving no frictions and uncertainties, the Robertson

presumption in favor of declining prices has no particular validity, since a golden age with price stability or steady price rise leads to no worse results.

b. But I must not put words in Professor Robertson's mouth. He no doubt had in mind a world with a reasonable degree of uncertainty. Once any appreciable elements of uncertainty are in the picture it is remarkably hard to make normative statements at all: we pass this way only once, the Bible says, and even a lunatic can say, "If you believed what I believed was going to happen, and feared what I feared was going to happen, you would have to admit that it was not irrational of me to wear knight's armour to the factory."

But let us be pragmatic in good English fashion and try to form normative judgments. Professor Robertson, as I understand it, has not said that in principle falling prices are good because that happens to splash <u>his</u> cautious friends with extra real goods; because to that you could answer that rising prices are good because that splashes your deserving risk-taking friends with real goods. His attempt to set up as in some sense approximately good the condition that would tend to prevail if money were "neutral" and did not distort natural barter arrangements would at bottom I suppose reflect the rough notion that interpersonal

presumption in favor of declining prices has no [illegible] when a [illegible] with [illegible] stability or steady price rise leads to no worse results.

4. [illegible]

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equity aside, a situation free from price-level distortions is more likely to be efficient in the technical sense of "Pareto-optimality." Now it has come to be conceded pretty much everywhere that there is no guidance to choosing generally between feasible situations to be found in concentrating only on Pareto-optimality properties of alternative situations. But is it true that balanced falling prices with the dollar buying more as technology improves brings a greater degree of Pareto-optimality than would stable prices or slowly balanced price rises? To the extent that foresight prevails, the answer is obviously no. To the extent that there are errors of foresight, no one that I can recall has demonstrated a presumption of greater Pareto-optimality in gentle secular deflation as compared to steady price levels, or for that matter gently rising price levels. Unless I have overlooked something, some new types of argumentation would have to be supplied before one could draw any such conclusion.

19. What price stable prices? Abstract models having established no presumptions, we must turn to feasibility conditions. Here, fortunately, there can be a general agreement. Given the institutional rigidities of a modern economic system, most experts agree that the attempt to shape fiscal and monetary policy to produce a trend of declining prices will

have grave consequences for total unemployment and production growth. At best (or worst), it is argued society should want to aim for steady prices. As the American Commission on Money and Credit has concluded, this involves the difficult choice of which index to stabilize: wholesale prices, consumer prices (or the so-called cost of living), or the Gross National Product deflator? Stabilizing wholesale prices would entail in the modern world a rise in the consumer price index of more than one per cent per year in the long run, for the reason that there is slower productivity gain (as the statistician ... measures it) in the services sectors of the economy than in the goods sectors. A still greater rise in the GNP Deflator would seem probable. The Commission on Money and Credit also pointed out that recent researches have suggested that official index numbers are almost necessarily biassed upward in that they fail to make appropriate allowances for quality improvements: if the official Consumer Price Index is reported to rise at one per cent per year, the error here involved suggests that a dollar is probably just about holding its own in terms of true purchasing power as measured by the utility of goods it will buy. A small economy that is open to the rest of the world must have a price trend pretty much set for it from abroad if it insists on fixed foreign exchange rates. If world price indexes could be held to a long-term rate of increase that averaged out over buoyant and dull epochs to not much more than one per cent, there

[illegible] (in [illegible]) [illegible] [illegible] [illegible] the [illegible], Commission on Money and Credit [illegible] [illegible], this [illegible] the [illegible] [illegible] of [illegible] index to stabilize: wholesale prices, consumer prices (or the so-called cost of living), or the [illegible] [illegible] prices would exist in the economy [illegible] a rise in the consumer price index of more than one per cent per year in the long run, for the reason that there is almost productivity gain [illegible] ... [illegible] in the services sectors of the economy than in the goods sectors. A still greater rise in the GNP deflator would seem probable. The Commission on Money and Credit also pointed out that recent [illegible] have suggested that official price indexes are almost [illegible] biased upward in that they fail to make appropriate allowances for quality improvements: if the official Consumer Price Index is permitted to rise at one per cent per year, the writers here involved suggest that a dollar is probably just about holding its own in terms of true purchasing power as measured by the quantity of goods it will buy. A small economy that is open to the rest of the world must have a price trend pretty much set for it from abroad if it insists on fixed foreign exchange rates. If world price increases could be held to a long-term rate of increase that averaged out over [illegible] [illegible] [illegible], to not much more than one per cent, there

would still be the problem that certain elements in the community - particularly in the lower income classes - will find that the savings they set aside for retirement in the future are likely to show a diminution of real yield. With higher rates of price increase this problem becomes still worse. Since statistical researches suggest that the principal victims of mild inflations are the old as against the young, there is a strong case for helping these groups adjust to the problem. This might involve: (i) purchasing-power bonds, annuities, saving accounts, and equity funds being made available to people on favourable terms by government aid, but in limited amounts; (ii) more pay-as-you-go private pensions; and finally, (iii) what is already a universal fact of modern life, social security benefits that keep up with the taxable capacity of the notion and with the price level. Such measures need not weaken the fight against undesirable inflation. Nor is it true that the "purpose" of the inflations we have to fear is precisely the cheating of the old, so that sliding-scale adjustments in their favor will only speed up the rate of demand inflation to accomplish again this purpose. The inflation dangers ahead are more likely to be of the "cost-push" or "sellers'" type, or of the cataclysm type that come in the wake of war and social disorganization.

20. Incompatibility of objectives. It would be nice if modern mixed societies would have the frictionless price flexibility to permit us always to have

[illegible] certain elements of the community — particularly in the lower income groups — will find that the savings they set aside for retirement in the future are likely to have a [illegible] real yield. With higher rates of price increase the position becomes still worse. These observations nevertheless suggest that the principal victims of mild inflations are the old as against the young. There is a strong case for helping these groups adjust to the problem. This might involve: (1) purchasing-power bonds, annuities, saving accounts, and equity funds being made available to people on favorable terms by government aid, but in limited amounts; (2) more pay-as-you-go private pensions; and finally, (3) what is already a universal fact of modern life, social security benefits that keep up with the taxable capacity of the nation and with the price level. Such measures need not weaken the fight against undesirable inflation. Nor is it true that the 'purpose' of the inflations we have to fear is precisely the cheating of the old, so that eliminating such adjustments in their favor will only speed up the rate of demand inflation to accomplish again this purpose. The inflation dangers ahead are more likely to be of the "cost-push" or "sellers'" type, or of the [illegible] type that come in the wake of war and social disorganization.

[illegible]. Incompatibility of objectives. It would be nice if modern mixed societies would have the frictionless price flexibility to permit us always to have

price stability without jeopardy to sustainable growth and efficient employment at high levels. It would also be nice if motors turned with less friction and if TV sets could grow like weeds. The facts of life, alas, are not all ideal; and while they are mutable, it is one of the facts of life that they cannot be changed in the easy way men might wish. As evidence accumulates, suspicion mounts that there will arise many occasions when society will find a clash between approximate price stability and tolerable sustained high employment and growth. I know that some experts deny this: in my files I have a number of such denials by eminent bankers and scholars. I wish that they were more convincing, because life would be better if there were no "trade-offs" between objectives and no need to compromise between evils. The Commission on Money and Credit ended up worried by this problem; and it is my guess that even their Report is too optimistic. This is not an issue that can be decided by reason or be decided on the basis of past experience. Nor is there a need to come to a firm decision before the fact. Yet it is essential to have one's thinking alerted to the problem and to prepare tentative strategies for handling events as they materialize. Now precisely because it is economically false that monetary policy has some special potency to affect the P in P$\times$Q, I must assert boldly: <u>The problem of determining how much price rise will be tolerated in the interest of a longer and growing output and employment is every bit as</u>

[illegible]

[illegible]

It is one of the [illegible] of life that they [illegible] in the [illegible] way men might [illegible]. [illegible]

[illegible] very [illegible]. In [illegible] I [illegible] by [illegible] and [illegible]. I [illegible] that [illegible]

[illegible] the P in [illegible], I must [illegible]

[illegible]

much a problem for fiscal policy as it is for monetary policy. There is no reason in logic or ethics why the central bank should be the agency for pulling the compromise in one direction -- say, the dis-inflationary direction -- rather than the government (be it Parliament, the Executive, or the Treasury). Indeed non-elected officials who hold long-term office and who are permitted wide freedom in their actions are not at all the ones in a responsible democracy to resolve these problems. This does not deny that the people through their legislature may choose to set up a quasi-independent agency to represent them in this regard. Except by the Darwinian test of survival of certain older central bank attitudes, there seems to be little evidence that the people have chosen to make such a social compact. It is in this sense that every central bank is responsible to government and not really independent.

III. Conclusion

21. Miscellaneous items. This testimony is already long. Yet I have barely scratched the surface of many relevant issues. Since time will not permit discussion of them in the depth they deserve, I shall simply list a number of opinions that could be elaborated on in oral testimony or at some later date.

1. A country like Canada might gain a good deal from a system of flexible exchange rates, in contrast to the stable exchange rates of some large powers like the United States.

2. While open-market operations and required reserve requirements are the important tools of conventional central banking, the earlier Canadian experiment with a <u>discount rate that changed rather flexibly</u> with respect to market bill rates has much to recommend it. The limited advantages of having something dramatic to announce when a change in market conditions is desired might still be preserved by having certain special differentials decreed at such times.

3. The goal of faster <u>growth</u> can be achieved in a mixed-enterprise economy, if at all, primarily by one mechanism -- namely, by conventional and unconventional monetary policies designed to stimulate a long-term deepening of capital, with the corresponding reduction of the proportion of consumption as a fraction of full-employment product being achieved by a compensatingly tight fiscal policy that prevents demand-pull inflation. This means that money cannot by its nature be "neutral" and hence the notion that central banking can be over and beyond responsible political decision making is quite untenable.

4. Every modern central bank should be made clearly responsible to the democratic government in power. This does not mean making it a mere branch of the Treasury. Nor does it require short terms of office for central bankers. Nor does it deprive the governor of the central bank of his freedom in day-to-day operations. Nor does it rob him of his power to nag publicly and privately. Nor does it take away

from his ultimate weapon -- dramatic resignation in public protest against what he deems to be bad policy. But it does mean that, after due process and agreed-upon delay periods, he must either yield to governmental policy or be subject to removal from office. There is no room in a modern democracy for a Fifth Estate, which serves as an insulated pocket of power set up to accomplish its own purposes be they good or be they bad. Freedom of a democracy to make its own mistakes is not merely a desideratum: it is an inevitability.

[illegible]

[illegible] mental policy is to be subject to removal from office. There is no room in a modern democracy for a Fifth Estate, which derives no [illegible] power of government set up by recognition [illegible] its own purposes be they good or be they bad. Freedom of a democracy to enact its own [illegible] is not merely a desideratum. It is an inevitability.

Royal Commission on Banking and Finance

DR. A.K. EATON.
THE CANADIAN CHAMBER OF COMMERCE.

Hearings held at

OTTAWA

Vol. 51

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Toronto, Ont.

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ROYAL COMMISSION ON BANKING

AND FINANCE

Hearings held at Ottawa,
Ontario, on Tuesday,
October 23rd,1962.

THE COMMISSION

The Honourable Dana Harris Porter
Chief Justice of Ontario
Toronto, Ontario - Chairman

Mr. W. Thomas Brown, M.B.E.
Investment Dealer
Vancouver, British Columbia

Mr. James Douglas Gibson, O.B.E.
Banker
Toronto, Ontario

Mr. Gordon L. Harrold
Agriculturalist
Calgary, Alberta

Mr. Paul H. Leman
Corporation Executive
Montreal, Quebec

* Mr. John C. MacKeen
Corporation Executive
Halifax, Nova Scotia

* Dr. W.A. Mackintosh,
Vice-Chancellor
Queen's University
Kingston, Ontario

Mr. H.A. Hampson - Secretary

Mr. Gilles Mercure - Joint Secretary

* Absent (Commissioner MacKeen present during afternoon session.)

Ottawa, Ontario,
Tuesday,
October 23rd, 1962.

--- On resuming at 9.15 A.M.

SUBMISSION OF

DR. A.K. EATON

THE CHAIRMAN: Dr. Eaton, it is a pleasure to see you again.

DR. EATON: Thank you, sir.

THE CHAIRMAN: We will proceed with discussion of your paper on your analytical comment on the Canadian tax structure. Have you any preliminary remarks you wish to make?

DR. EATON: No sir, I think I have none.

THE CHAIRMAN: We will then proceed with the discussion.

DR. EATON: Yes, sir.

COMMISSIONER BROWN: Mr. Chairman, I suppose before we start discussing the tax structure we should make it clear that as far as this Commission is concerned we do not want to get into fields that more properly belong with the Royal Commission on Taxation. However, at the risk of that, I think we would like to discuss the effects of taxation on capital flows and capital accumulation. I would like to start by referring to paragraph 27 of your brief in which you refer to the fact that a large part of income from investment of savings is not subject

to income tax. That is through house ownership, pension funds, insurance policies, and you also refer to a certain number of bond coupons that are cashed without being subject to taxation.

DR. EATON: That is right.

COMMISSIONER BROWN: What I want to ask you is whether, in your opinion, this form of accumulation tends to over-emphasize the conservative type of investment and reduce the amount that would be going more directly into equities?

DR. EATON: Well, I would say generally that it does through the very nature of the part that these savings play. Take the insurance companies: their general policy is to match debt with debt. Now, at least, they are broadening out a little in their equities; but generally I would say the insurance money does go into debt. Pension people, generally, certainly much more so in this country than in the United States, will have the bulk of their funds in debt securities. Some of the larger funds in the United States come almost close to half in equities. I think General Motors is up around 38 per cent or 40 per cent in equities. Certainly in the annuities, government annuities particularly, I would say generally these items I have listed are mainly in debt rather than equity capital, or over in the debenture capital field, and I think it is too bad; I would like to see more of it spread out into equities, but I don't know quite what you can do about it. You can legislate them into that, but it is a pretty risky thing for a

it is known that that is through bonus dividends, pension funds, insurance policies, and you also refer to a certain number of bond coupons that are cashed without being subject to taxation.

DR. [illegible]: That is right.

COMMISSIONER [illegible]: What I want to ask you is whether, in your opinion, this form of accumulation tends to over-emphasize the conservative type of investment and reduce the amount that would be going into [illegible] investment.

DR. [illegible]: Well, I would say generally that it does increase the very [illegible] of the part that these savings play. That the insurance companies' their general policy is to be more [illegible] with them. Now, at least, they are [illegible] out a little in their equities, but generally I would say the insurance money ends in [illegible]. Foreign [illegible], generally, especially much more so in this country than in the United States, will have the bulk of their funds in [illegible]. Some of the biggest in the United States have [illegible] to [illegible] in equities. I think [illegible] is up around [illegible] per cent or so per cent in equities. [illegible] in the equities, government securities particularly, I would say generally these funds I have [illegible] are mainly in debt rather than equity capital, as [illegible] in the debenture capital field, and I think it is too bad; I would like to see more of it spread out into equities, but I don't know quite what you can do about it. You can legislate them into that, but it is a pretty risky thing for a

government to push funds or urge funds over into more risky investments. Generally, I think it is a fair generalization that you have made about the direction. I don't think that is mainly because they are tax-exempt through this period. I think it is more the actual flow than the policy of people who are managing these funds. I don't think there is more investment, say, in government bonds merely because quite a package of it escapes tax. I have seen people cashing their coupons in small pieces in different banks so they will not have a large enough sum in one lump to have to be reported through ownership certificates. There is quite a bit of that.

COMMISSIONER LEMAN: You did not get them arrested?

DR. EATON: Well, the banks are not inclined to cast too particular an eye on offending people in these directions.

COMMISSIONER BROWN: The next point I wish to ask you about is in reference to paragraph 31 where you comment that if the personal income tax rates above 50 per cent were cut off -- in other words, reduced to 50 per cent, the tax cost would be less than $10 million; and further, if it was a 40 per cent ceiling it would cost $40 million. I wasn't quite sure what you were getting at there. Is it that this change would not cost the government very much, or would not produce very much money available for investment?

DR. EATON: What I mean there mainly is that

[illegible]

[illegible]

[illegible] generalization that you have made about the direction. I don't think that is mainly because they are [illegible] [illegible] [illegible]. I think it is more the [illegible]

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[illegible] [illegible] [illegible] it would [illegible] [illegible]. I wasn't quite sure what you were getting at there. Is it that this change would not cost the government very much, or would not produce very much money available for investment?

MR. [illegible]: What I meant [illegible] [illegible]

these high rates are not very necessary, although, after having said that, you can say that if you reduce them you would not have freed much additional capital for investment. That is the disappointing part of it. It is quite another story if you brought it down to the flat rate of 16 per cent, which I have commented on -- that that would produce the same revenue -- and you would get something of the order of 200 million a year freed through dropping the rate to 16 and bringing the others up to 16. There would be a couple of hundred million more money available for investment, with people paying 16 where they now pay up to 20 or 25. I think I am suggesting here that this would make good sense, and partly it is not entirely the amount of revenue. I think an awful lot of people just plain resent those rates and do whatever they can to avoid it, and enter into all kinds of methods and techniques of avoiding them, and they are generally against income tax because of these high rates. I think that is bad, and I don't think it is necessary. I think these very high rates, certainly above 50, just do not make good sense from anybody's point of view -- except the socialists; they like that.

COMMISSIONER BROWN: But, in fact, at these levels it would not produce too much available for investment?

DR. EATON: No, no; I agree with that entirely. It is amazing the smallness of the amount of revenue you get through the high rates, and it was this general

[illegible]

[illegible] necessary.

MR. [illegible]: Yes, yes. I agree with that entirely. It is amazing, the smallness of the amount of revenue you get through high rates, and it was this general

fact which was revealed so clearly in the years when we had the investment income tax right across the board. We were just getting peanuts out of it. It is amazing the small amount of investment income there is in this country; that is, I suppose, that there hasn't been the opportunity to accumulate great wealth in the middle and upper income brackets. We are just a poor country, and this sort of thing just keeps on that way.

COMMISSIONER BROWN: You mean in the hands of individuals?

DR. EATON: Yes.

COMMISSIONER BROWN: On the question of corporations, I would like to get your comments on whether, in your opinion, the tax structure including the capital costs allowances perhaps over-encourage the retention of earnings and cash flow by corporations; in other words, what is your reaction to the proposition that has been expounded several times by Mr. Kierans of the Montreal Stock Exchange, that corporations should be encouraged to push out these retained earnings and let the market decide how corporation funds are invested?

DR. EATON: I have never really understood completely his analysis of this. No, I am not in favour of that. I think from the point of view of the country it is all to the good that earnings are retained instead of pushed back out and subject to such high personal income tax rates. I think it is a bit encouraging -- and it is just in its beginnings yet --

the new businesses and other new shows that has been announced recently of using upstairs money for financing, not their own businesses, but new businesses outside. I am very encouraged to see that happen, and I think it is a good thing, rather than having the large grow larger and still be able to finance and take on as an outside form what the Industrial Development Bank is trying to do mainly through debt. I do not think they take equities at all; I think they can, but I don't think they do very much. So, rather than put all these smaller companies into debt, if these big shows with pots of money would get into an equity position with some of the smaller outfits, I think it would be all to the good. I would not like to see a piece of law to encourage the dispersal of more capital funds back into the public. As a matter of fact, I think the big shots in industry are better judges of where money should be put than the general public. This is old theory: we had this all through the New Deal stage in the United States. They came in at one stage with a tax on undistributed income purposely to encourage this sort of thing. It didn't last very long; I have forgotten whether it ever got on the statute books, but the New Deal crowd were imbued with this idea, and I don't go along with it.

COMMISSIONER BROWN: One of the arguments that has been advanced is the fact that -- and this is from D.B.S. figures -- that assets in manufacturing after depreciation in the ten years 1950 to 1959 grew from 9.1 billion to 20.1 billion while profits increased only

from 1.3 billion to 1.57 billion, which is a return of only 2.4 per cent after tax. People have read into these figures that perhaps business has not been so smart in its expansion.

DR. EATON: I don't suppose I am too sophisticated in this. Let me give you an example: Mr. Capon of DuPont has got quite upset about this very question, and he wrote an article in the Financial Post recently, and he and I are going on a Tax Foundation programme on this very question. He feels much the same as Kierans does -- I don't know whether it is for the same reason -- but here is the Vice-President and Treasurer of DuPont, and he, looking particularly over the situation, thinks it would be a good idea if corporations were made to disperse practically of their earnings, and he is making a proposal to that effect. He has done so in print, and he is going to go on to the platform on the same issue. Perhaps I am not familiar enough with the inside workings to know whether they are over-investing. My impression is that I don't like the idea of forcing earnings out.

COMMISSIONER BROWN: Let us say if this could be done, and adjustments made so that the total tax take remained the same?

DR. EATON: Even so, I don't think so. I keep coming back to this question of trying to see industrial earnings free from too high personal income taxes. There is a lot of tax free gain in the hands of the individuals through the ploughing back of earnings.

[illegible]

[illegible]

DR. [illegible]: I would suppose I can [illegible] to [illegible]. Let me [illegible]: Mr. [illegible] of Dutch [illegible] quite [illegible] very [illegible], and [illegible] in the [illegible] recently, and he and I were going on a [illegible] programs [illegible] the [illegible] of [illegible] -- I don't [illegible] -- [illegible] reason, because I am just [illegible].

[illegible]: Let me say if this could be done, and [illegible]

DR. [illegible]: [illegible], I don't think [illegible] keep coming back to this [illegible] of trying to [illegible]. There is a lot of [illegible] of the [illegible] through the [illegible] of [illegible]

There is a big tax-free gain, if you like, made by the holders. This would not happen any more; if you are going to force out earnings, you won't have this growth factor in industry. Perhaps you say it is exaggerated and it is not paying off as high as it should, but to the extent you keep pushing all of these earnings back into the personal income tax ranges, I think it is bad.

COMMISSIONER BROWN: If my premise carried, and that is, if the total tax take remained the same -- in other words, there was still the same amount of money over-all available for investment, but the individual shareholder had a greater opportunity to direct that investment?

DR. EATON: Well, you can say, "If the same total amount were available..." -- I doubt if it would find its way back. Perhaps I am sliding past your question here, but if it is available I don't think it would find its way back -- certainly with not as much certainty as now. That is, if you had this so that it was free, there would be more of a tendency to spend it in other directions rather than industry. I haven't any confidence that if you did push it up you would get anywhere near the same amount back for investment in industry.

You can counter that, and say, where it is being invested it is not being invested to the best advantage. That may be so; I can't really answer that, but I am always suspicious of these derivations from these total lump increases that are put out. I don't

There is a big increase like, we see it, here is the surplus. This would not happen and have;

if you are going to force out earnings, you won't have this growth factor in industry. Perhaps you may it is exaggerated and it is not paying off as high as it should, but to the extent you keep pushing all of these earnings back into the personal income tax ranges, I think it is bad.

COMMISSIONER BROWN: If my question carried, and that is, if the total tax take remained the same -- in other words, there was still the same amount of money that was available for investment, but the individual shareholder had a greater opportunity to direct that investment?

MR. [illegible]: Well, you can say, "If the same total amount were available..." - I doubt it would find its way back. Perhaps I am sitting past your question here, but it is possible I don't think it would find its way back -- certainly with not the same certainty as now. That is, if you had this money, as it was free, there would be more of a tendency to spend it in other directions rather than industry. I haven't any confidence that if you did pass it on you would get anywhere near the same amount back for investment in industry.

You can counter that, and say, where it is being invested it is not being invested to the best advantage. That may be so; I can't really answer that, but I am always suspicious of these projections from these total lump increases that are put out. I don't

question the Bureau of Statistics: it is just a derivation from totals that they have got.

COMMISSIONER BROWN: Let us look at the same thing from a slightly different anle: does the tax structure -- I am not thinking of income tax now so much as the fact that construction materials and machinery have certain exemptions from manufacturers' sales tax: does this sort of tax structure over-encourage business in investment as against consumer spending?

DR. EATON: I take this point of view, that this is, in fact,avoiding a pyramiding of tax. Certainly for this country it is vastly important that we not have a sales tax on the equipment for producing goods for export. If you had it on all machinery and equipment it would not be anything too tragic -- if you had pyramiding of tax on equipment for domestic purposes, but it would be bad if you had it on equipment manufacturing goods for export. This is one of the things our businessmen are so confused about. They think there are incentives given in the European tax system which make it difficult for them to compete because they give exemption from their sales taxes and turn-over taxes in Europe, whereas, in fact, we have always done that. We have exempted the machinery, and equipment producing goods for export. When Europeans, with different types of systems, start doing that, we howl to the high heavens about it, whereas, in fact, we have never had that sort of thing in our system. I would not say that is a positive encouragement to more

[illegible]

CONGRESSMAN BROWN. [illegible] of the same thing from a [illegible] different [illegible]. Does the tax structure -- I am not thinking of income tax now so much as the fact that construction materials [illegible] manufacturers' sales tax [illegible] this sort of [illegible]

[illegible]

[illegible] If you had [illegible] in [illegible] [illegible] which there are [illegible] [illegible] because [illegible] give [illegible] [illegible] we have [illegible] the machinery [illegible] with different types of [illegible], [illegible] doing that, we come to the high [illegible], in fact, we have [illegible] I would not say that [illegible] to move

investment. It is just the removal of an obstacle which otherwise should not be there.

COMMISSIONER BROWN: These are all points that rather encourage the accumulation of capital and its use, are they not -- these several points we have been discussing; that is, the retention of earnings in corporations and these taxes as well?

DR. EATON: I don't know that I would say it is a positive encouragement. I certainly would not agree that the absence of a sales tax on machinery and equipment would be regarded as a positive incentive. I would say it is just the removal of what would otherwise be a positive obstacle. As for the retention of earnings, it is just a free country, and the directors decide what is fair to disperse and what is better to keep. I don't know whether I might come back on this same point, reverting to the point you made, that if the same volume of funds were available for investment wouldn't that be a better situation: I think no. Here I don't want to get too far on this, but today the incidence of that corporate tax, I believe, is mainly passed on to consumers. I would not like to see a large part of this shifted back -- shifting from consumers generally back on to the middle and upper group of income tax papers. I think this system of corporate tax is there and is passed on and that they are not compelled to disperse.

incentive. It is getting the payment of an economic which otherwise would not be there.

SENATOR [illegible]: Those are all points that relate to encourage the expenditure of capital and the use, are they not -- these several points we have been discussing, that is, the reduction of earnings in corporations and their taxes on that?

MR. BATES: I don't know that I would say it is a positive disincentive. I certainly would not argue that the existence of a market for our machinery and equipment would be regarded as a positive incentive. I would say it is just the thought of that would otherwise be a positive incentive. As for the reduction of earnings, it is just a flat penalty, and the disincentive position that is felt by companies are most affected by that. I don't know whether I might come back on this same point, recurring to the point you make, that if the same volume of investment available for investment purposes that is a better situation; I think so. But I don't want to get too far on this. I'd think the incidence of that corporate tax, I believe, is mostly passed on to consumers. I would not like to see a large part of this shifted back -- shifting from consumers generally back on to the middle and upper groups of income tax payers. I think this system of corporate tax is fairly and is passed on and that they are not completely to disappear.

I think that gives the best direction for the incidence of this tax, and the greatest prospect of getting more capital for investment.

COMMISSIONER BROWN: You have a section on the incidence of this tax.

DR. EATON: I did not mean to push into that, but it is another aspect.

COMMISSIONER BROWN: It is another aspect of the whole thing. I am not sure that the figure 2.4 per cent after tax always bears out the over-all contention -- it is probably beyond our scope, and is the lot of another commission.

THE CHAIRMAN: Have any of the other Commissioners questions on this point?

COMMISSIONER LEMAN: Before we leave the section that Commissioner Brown was talking about, referring to your paragraph 42, Dr. Eaton, you make the point there that apparently the corporate tax system at its relatively high rate comparative to what people had been used to pre-war surprised everybody; there were a great number of people who had thought that this would slow things down a great deal, but it does not seem to have done that. What do you think about the length of test you are talking about there? Is it a long enough test? Are there circumstances during and after the war that make it appear that this high rate of tax has not hurt us, which would not necessarily be true over a longer period of time and in a completely different set of competitive circumstances.

DR. EATON: Well, I don't know. Certainly we are at a time, both here and in the United States, where both countries are worried about their growth factor slowing down -- things are not growing as they should. This is what the classical economist says: Just you wait -- they won't be able to keep passing the tax on forever; when you get into tough competition you will find trouble absorbing the tax.

Well, it may happen -- I don't know. It does seem to be thoroughly into the industrial planning and price policy and so on, just to take the corporate tax as a cost, and say we have to recover this and this -- to look at the after-tax profits. I don't know whether that will work in. Perhaps there will be a few who will in effect absorb it and start cutting prices. But I don't look for it to happen on any great scale. I think there will just be a slowing down rather than a relief to the system through absorbing the tax. That, I think, will be the natural result.

Your suggestion was that the system of passing the tax on in higher prices would not always persist. Well, I am inclined to think it will.

COMMISSIONER LEMAN: What I am asking you about is your judgment of what a certain level of corporation taxation can do to an economy over a period when most of the time we are in what was considered a seller's market, and whether you might not change your opinion if during an equal period in length of time

[illegible]: Well, I would think, [illegible] we are at a time, both here and in the United States, [illegible] factor slowing down -- things are not growing as they should. This is what the classical economist says: Just you wait -- they won't be able to keep passing the tax on forever; when you get into tough competition you will find trouble absorbing the tax.

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COMMISSIONER LAMAN: What I am asking you about is your judgment of what a certain level of corporation taxation can do to an economy over a period when most of the time we are in what was considered a seller's market, and whether you might not change your opinion if during an equal period in length of time

you were in a buyer's market.

DR. EATON: I don't know. It might shade off; perhaps a lesser amount would be passed on in higher prices. However, I cannot see it happening as a general rule, that profits will absorb the full amount of this 50 per cent corporate tax. Somehow, I just can't see it happening.

COMMISSIONER GIBSON: You see, Dr. Eaton, the normal difference is between industries in their abilities to pass the tax on. Let us take two extremes: you mentioned utilities, where there is a great deal of evidence of the tax being passed on. The other extreme is, let us say, some industry like the needle-work trade, relatively small units, and with a great deal of competition. Do you think it will be successful in passing the tax on?

DR. EATON: Well, if you get down to the smaller companies, they only have 21 per cent tax as compared to 50 per cent. It may not be so obvious.

Now, I think I will have to agree that where the competitive situation is very tough, there will always be some who are unable to pass on the tax. But within a fairly wide range there will be a group who operate efficiently enough to meet the market and pass it on. There will be industries which have difficulty in passing it on, but I do not think that will be true of everyone.

COMMISSIONER GIBSON: We have heard quite a bit in the last three or four years about the problems of some of our domestic industries to meet the import

you were in a buyer's market.

DR. EATON: I don't know. It might shade off; perhaps a lesser amount would be passed on in higher prices. However, I cannot see it happening as a general rule, that profits will absorb the full amount of this 10 per cent corporate tax. Somehow, I just can't see it happening.

COMMISSIONER [illegible]: You do say, then, the normal difference is between industries in their abilities to pass the tax on. Let us take two extremes: you mentioned utilities, where there is a great deal of evidence of the tax being passed on. The other extreme is, let us say, some industry like the textile-wear trade, relatively small units, and with a great deal of competition. Do you think it will be successful in putting the tax on?

DR. EATON: Well, if you get down to the smaller companies, they only have 20 per cent tax as compared to 47 per cent. It may not be so obvious.

But, I think I will have to agree that where the competitive situation is very tough, there will always be some who are unable to pass on the tax. But within a fairly wide range there will be a group who operate efficiently enough to meet the market and pass it on. There will be industries which have difficulty in passing it on, but I do not think that will be true of everyone.

COMMISSIONER GIBSON: We have heard quite a bit in the last three or four years about the problems of some of our domestic industries to meet the import

competition they face. That is what I am thinking of.

DR. EATON: I expect there will be cases where they will meet the import market, regardless of profit. The point is, we don't know enough about this whole question. I would like to see the Royal Commission on Taxation make a very definite study of this whole matter. I do not pretend to be too wise about it. I am just reporting here my experience in these things, and it is not very widely based. That seems to be the feeling of all of us who are sticking our necks out on this question. You need a lot more study on it.

The theory of what you can do to the tax system hinges very much on this very point; it is a most important one. Even with respect to the services industries, you asked me whether they could pass the corporate tax on. I don't know whether they do it or not. It is not just a question of selling things and marking them up. This is quite a complex situation, where you try to recover. There is a whole range of industries that I don't know about or haven't any views on. This is just through lack of knowledge.

COMMISSIONER BROWN: Is your general thesis based on the assumption that to the extent new capital is invested and has been invested since the tax rate of 50 per cent became standard, that tax rate is taken into consideration as a factor in determining whether the investment will be a good one or not?

DR. EATON: Yes, I think there is that con-

competition [illegible]. That is what I am getting at.

DR. EATON: I expect there will be places

where they will meet the import market, regardless of profit. The point is, we don't know enough about this whole question. I would like to see the Royal Commission on Taxation make a very definite study of this whole matter. I do not pretend to be too wise about it. I am just reporting from my experience in these fields, and it is not very wisely based. That seems to be the trouble of all of us who are thinking our troubles on this question. You have a lot more ideas on it.

The theory of what you can do to the tax system changes very much at this very point. It is a most important one. Even with respect to the [illegible], you cannot say whether they would pass the consumer [illegible]. I don't know whether they do it or not. It is not just a question of selling things and marking them up. This is quite a complex situation, where you try to recover. There is a whole range of [illegible] that I don't know about or have [illegible] on. This is just through lack of knowledge.

COMMISSIONER [illegible]: If your general thesis based on the assumption that to the extent new capital is invested and has been invested since the tax rate of 50 per cent became standard, that tax rate is taken into consideration as a factor in determining whether the investment will be a good one or not?

DR. EATON: Yes, I think there is that con-

sideration.

Therefore, to that extent, it must be passed down to the consumer.

DR. EATON: Yes. But I think it is true of products from previously existing capital, that they will do the same. I don't think it is just limited to new capital. That is where the decision will be made as to whether new capital will be invested or not, but I think the general practice has been established from existing capital, for they are recouping there as well.

THE CHAIRMAN: There is one other factor I should like to ask you about. The consumer, for the most part, is also a wage earner, and his wages have increased very substantially over this same period. Then, when you say that the tax is passed on to the consumer, something is also passed on to the consumer by way of increased wages to enable him to absorb that tax, and wages come out of industry.

Looking at the whole picture, and taking all these factors into consideration, what is the net result?

DR. EATON: I think the net result is this: In so far as the labour groups are successful in getting higher wages -- perhaps beyond productivity, perhaps not -- that it is relatively automatic with the manufacturer or the industry to mark-up on the basis of their additional costs; that goes out, and the consumer pays what he has to pay after this process has gone one.

I think generally speaking that has been the pattern, and it has been relatively automatic. I don't think we can expect industry to take any other position when there is the alternative -- and they are all tending towards it -- to pass it on in higher prices. I think that is pretty much the pattern. Certainly it has been in the United Kingdom. Over there they are trying to meet the higher wage costs. The unions see that they can get it by pushing hard, and that goes into the higher prices. Of course, at the same time, the consumers are for the most part wage-earners.

COMMISSIONER BROWN: Just to follow this question a little further, to the extent that it can't be passed on, say in the export industry, then it is either absorbed or the investment does not take place?

DR. EATON: Yes, that is true, although I do think it is a pretty safe generalization that people who are exporting to Canada are attempting to do the same thing, in passing on their own corporate tax, most of whom are about on the same level as ourselves. We used to wonder more about that than we do now -- what our position would be in international trade. There is some comfort in seeing that the same thing happens in other countries. However, there is an exception with respect to the United Kingdom. I don't know quite what I would say if these hearings were being held over there, and I was asked whether their income tax plus their corporate tax was being passed on to the consumer. I think generally it is, but it is not

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Congressman Boggs: Just to follow this question a little further, to the extent that it can't be passed on, may it not impair industry, that it is either absorbed or the investment does not take place?

Mr. Hutton: Yes, that is true, although I do think it is a pretty safe generalization that people who are exporting to Canada are attempting to do the same thing, in passing on their own corporate tax. Most of them are about on the same level as ourselves. We tend to worry more about that than we do now -- what our position would be in international trade. There is some comfort in seeing that the same thing happens in other countries. However, there is an exception with respect to the United Kingdom. I don't know quite what I would say if these hearings were being held over there, and I was asked whether their income tax plus their corporate tax was being passed on to the consumer. I think generally it is, but it is not

such a clear pattern. The legal liability is not on the corporation over there; it is really on the individual. About half of the earnings are retained; so, a piece of it becomes a firm corporation tax. I expect they also attempt to recover that in higher prices.

The same is true in Australia, where they ha e recently had a commission on taxation. There about half the industrial earnings are retained and are re-invested. That seems to be quite a common pattern.

COMMISSIONER GIBSON: You would agree, Dr. Eaton, that where prices are set by competition from outside the country, whether for domestically produced goods or goods exported outside the economy, the process of pass ing on must be limited by this fact. Is that not correct?

DR. EATON: Yes. I am saying that where foreign companies are selling in Canada, they are attempting to recoup by passing it on in the price at which they sell in Canada; they do that in their own domestic markets. Generally speaking, I come up with the c onclusion that the corporate tax is not a very important factor in the competitive position between Canadians and foreign producers, either on import goods or on their own goods exported to other countries. I believe the pattern holds pretty well true that they are all attempting to recoup.

COMMISSIONER GIBSON: Suppose our corporate tax were raised today to a point where it would

were a great pleasure. The main [illegible] is not on the corporation over there; it is really on the individual. About half of the earnings are retained; so, a piece of it becomes a true corporation tax. I expect they also attempt to recover that in higher prices.

The same is true in Australia, where they have recently had a [illegible] of [illegible]. There about half the industrial earnings are retained and are re-invested. That seems to be quite a common pattern.

COMMISSIONER GIBSON: You would agree, Mr. Eaton, that world prices are set by competition from outside the country, whether for [illegible] produced goods or goods exported outside the country. The process of pass the [illegible] is limited by this fact. Is that not correct?

MR. EATON: Yes. I am saying that where foreign companies are selling in Canada, they are attempting to recoup by passing it on in the price at which they sell in Canada. They do that in their own domestic markets. Generally speaking, I come up with the conclusion that the corporate tax is not a very important factor in the competitive position between Canadians and foreign producers, either on import goods or on their own goods exported to other countries. I believe the pattern holds pretty well true that they are all attempting to recoup.

COMMISSIONER GIBSON: Suppose our corporate tax were raised today to a point where it would

be difficult for some industries to pass it on -- for instance, people who are selling copper, wheat, aluminum or newsprint -- it would seem to me that in the short run they couldn't pass it on.

DR. EATON: That is true.

COMMISSIONER GIBSON: They have a fixed price, and that is it.

DR. EATON: I would certainly agree that if our rate were jumped to 60 or 65 per cent it would hurt our competitive position. But if you look at our chief competitors -- for instance, there is the United States with 52 per cent, the United Kingdom with 38 per cent plus a straight 10 per cent which takes the tax up to about 48¼ per cent. I will not go through all the Continental tax rates, but there is a fairly common level. I come back to the picture that the corporate tax in Canada would make a difference of only a few percentage points. For instance, if you want to take as gospel the figure of 5 per cent mark-up, there is a 5 per cent profit margin on each dollar of sale. So, in order to retain that profit you would have to mark the price up by 5 per cent, and that would allow you to recover the whole of the tax. These are relatively small amounts.

In so far as any Continental country has a tax 5 or 10 per cent less than ours, this accounts for a very small difference in the price. I think this has been vastly over-rated as a competitive factor.

is difficult for the Canadians to pass it on. For instance, people who are selling copper, steel, aluminum or newsprint -- it would seem to me that in the short run they couldn't pass it on.

DR. [illegible]: That is true.

COMMISSIONER [illegible]: They have a fixed price, and that is it.

DR. [illegible]: I would certainly agree that if our rate were [illegible] to [illegible] per cent it would hurt our competitive position. But if you look at our chief competitors -- for instance, there is the United States with 52 per cent, the United Kingdom with 50 per cent plus a surcharge of [illegible] per cent which takes the tax up to about [illegible] per cent. I will not go through all the [illegible] countries [illegible], but there is a fairly common level. I just think in the picture that the corporate tax in Canada would make a difference of only a few percentage points. For instance, if you want to take as [illegible] the figure of [illegible] per cent [illegible], there is a 5 per cent profit margin on each dollar of sales, so, in order to recover that profit you would have to mark the price up by 5 per cent, and that would allow you to recover the whole of the tax. These are [illegible].

In so far as any international country has a tax 5 or 10 per cent less than ours, this accounts for a very small difference in the price. I think this has been [illegible] as a competitive factor.

COMMISSIONER LEMAN: Could we take the reverse proposition, and ask you if you believe that if the government gives an incentive to corporations in various forms, which amounts to a tax rebate, is it done because it is expected it will be passed on to the consumer?

DR. EATON: I don't know. But I think this logically follows from what I have been saying, that the impact of these incentives is pretty weak stuff.

COMMISSIONER LEMAN: In logic, if you really believe that a corporate tax is to be passed on, and if you give a tax incentive, it should revert ...?

DR. EATON: Yes. They should be able to compete a little better, to sell at a slightly lower price; but my point is, you have to have a large chunk of incentive before you can get the price down one, two or three per cent. You are working on a slim margin on this kind of thing.

COMMISSIONER BROWN: It has been suggested that if your contention were right, and if this corporate tax were in fact passed on to the consumer, the end result is a regressive form of tax equivalent to a sales tax?

DR. EATON: Yes.

COMMISSIONER BROWN: And as such it tends to lessen the impact of the highly graduated income tax.

DR. EATON: That is true.

COMMISSIONER BROWN: You will agree with that?

COMMISSIONER LIPMAN: Could we take the [illegible] proposition [illegible] that if the government gives an incentive to corporations in various forms, which amounts to a tax rebate, is it done because it is expected it will be passed on to the consumer?

DR. EATON: I don't know. But I think this logically follows from what I have been saying, that the impact of these incentives is pretty weak itself.

COMMISSIONER LIPMAN: In logic, if you really believe that a corporate tax is to be passed on, and if you give a tax incentive, it should reverse ...?

DR. EATON: Yes. There would be able to engender a little increase, as well as a slightly lower price; but to pass it on, you have to have a [illegible] kind of incentive unless you can hit the place immediately [illegible]. [illegible] working on a [illegible] this kind of thing.

COMMISSIONER BROWN: It has been suggested that if your supposition were right, and if these corporate tax were in fact passed on to the consumer, the end result is a regressive form of tax similar to a sales tax?

DR. EATON: Yes.

COMMISSIONER BROWN: And as such it tends to lessen the impact of the highly graduated income tax.

DR. EATON: That is true.

COMMISSIONER BROWN: The next point will, again, [illegible]

DR. EATON: Yes, I am in favour of it. I think it would be a good policy for Canada to lower her corporation tax and put on more sales tax, which would not apply to goods exported. That would improve to some extent the competitive position of Canadian industries in the world markets, through having a slight edge on the corporate tax, and pick up the revenue domestically. It would throw more burden on Canadians, but they would sell more abroad.

COMMISSIONER BROWN: It would cause dislocation between the service industries and the manufacturers?

DR. EATON: Yes. At the same time they should fix up the structure of exemptions from sales tax. That is an attrition that has gone on through the years, with more and more exemptions from sales tax. That, too, could be corrected.

COMMISSIONER BROWN: I would like to turn briefly to the question of the 20 per cent tax credit which you described as having been instituted in the first place at the 10 per cent level, as a means of avoiding duplicate taxation; but when it went up to 20 per cent, I think your phrase was that it was openly nationalistic.

DR. EATON: Yes.

COMMISSIONER BROWN: Can we get your comment as to why, with all these advantages for Canadians to own equities in Canada and get the 20 per cent credit, it is apparently so profitable for foreigners

to buy equities at prices higher than Canadians would be prepared to pay?

DR. EATON: There is more wealth abroad, and a lot of the foreign purchases are by corporations rather than by individuals. I think part of my thesis is that Canadians have not enough money left to buy the equities. I think the credit has been a help, but I have been disappointed that it has not resulted in broader ownership of Canadian equities by Canadians. That is why I would like to see it increased. I think there might be some scope for it to operate a little more broadly. But some people have said it has not made any difference; it has not encouraged buying.

I think the Tax Foundation touched on that matter some years ago. They did not make a statistical study of that sort of thing, but they offered the impression that it had not done very much to increase Canadian ownership of equities.

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I think the Tax Commission touched on that matter some years ago. They did not make a statistical study of that sort of thing, but they offered the impression that it had not done very much to increase Canadian ownership of equities.

Well, foreigners have not the advantage. They have not this additional incentive but they still seem to keep on buying. Although, I again keep coming back to the fact that a large volume of this buying on the market is by corporations and regular investment trusts in the United States which pay no tax; the corporations that are tailor-made for U.S. capital gains.

There are a lot of those who buy securities in Canada and hold them; they do not distribute them and just let the funds accumulate -- build up, and then years after they can sell out and take a capital gain for the whole of the earnings in Canada. I do not know whether those are going to be hit or not, but the United States is trying to kill that sort of thing. It has been threatening to do this for a long time but never has. They have recently tried to do that. That could make quite a difference in the ordinary volume of equities that are purchased by non-residents on the Canadian market. There has been quite a move very recently in this direction.

COMMISSIONER LEMAN: In that same discussion of the tax credit on dividends, Dr. Eaton, would you refer briefly to a detail in your paragraph 74? You claim there that with the tax credit we have had the result of removing the so-called doublt taxation on three-quarters of total taxation in Canada. This is three-quarters in numbers. This was when the reduction of tax on small corporations was on profits up to $10,000, and the dividend credit only 10 per cent

[illegible]

to keep on buying. Although, I again keep coming back to the fact that a large volume of this buying on the market is by corporations and regular investment trusts in the United States which pay no tax: the [illegible] capital gains.

There are a lot of those who buy securities in Canada and hold them; they do not distribute them and just let the funds accumulate -- build up, and then years after they can sell and they have a capital gain for the whole of the earnings in Canada. I do not know whether these are going to be hit or not, but the United States is coming to grips with some of them. It has been threatening to do this for a long time but never has. They have recently tried to do that. That could make quite a difference in the ordinary volume of securities that are purchased by non-residents on the Canadian market. There has been quite a move very recently in this direction.

COMMISSIONER [illegible]: In that same discussion of the tax credit on dividends, Mr. [illegible], would you refer briefly to a detail in your paragraph 74? You claim there that with the tax credit we have had the result of removing the so-called double taxation on three-quarters of total taxation in Canada. This is three-quarters in numbers. This was when the reduction of tax on small corporations was on profits up to $10,000, and the dividend credit only 10 per cent

etc., then you say:

> "Today the credit is 20 per cent and the low rate of 21 per cent applies to profits up to $35,000."

COMMISSIONER LEMAN: Would you give us a guess as to the result in numbers now affected favourably. Did it change the proportions?

DR. EATON: It would change that some. It would change it quite a bit. I would guess it is up closer to 85 per cent in the numbers of corporations. Perhaps that is an exaggeration. Perhaps it would not be more than 80 per cent. I would say in the range of 80 to 85 in the percentage of the number of corporations.

COMMISSIONER LEMAN: Well, through this discussion on this point of the tax structure, I do not know whether you come out very clearly as to whether you feel that the removal of double taxation as such is a worthy objective just for its own sake.

DR. EATON: No, I do not. My main thesis is that there is not any. That is, corporate tax, the tax paid by corporations is passed down to the consumer, therefore, they bear the incidence of corporate taxes. Then that has left the corporations, with this half; distributing the other half of the incidence on, with a quarter, if you like, that is passed out on the individual as a single tax. There is not any other tax which has been paid in fact and not

[illegible]

"[illegible] income [illegible] and that

ice range of 4[illegible] per cent, [illegible] to profits

up to $25,000."

COMMISSIONER [illegible]: Would you give me a

guess as to the result if [illegible] was abolished

[illegible]

MR. [illegible]: It would change that some.

It would change it [illegible]. I would guess it is up

closer to 75 per cent in the [illegible] of corporations.

[illegible] I would not

[illegible] I would say it [illegible]

of 70 to 75 in the [illegible] of the number of

corporations.

COMMISSIONER [illegible]

discussion on this point at the [illegible]. I do

[illegible]

you feel that the removal of double taxation [illegible] that

is a [illegible] for [illegible] we want.

MR. [illegible]: [illegible]

is that [illegible] Then [illegible]

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[illegible]

incidence [illegible] If you like, [illegible] be passed

out to the individual [illegible]. There is

[illegible] paid in [illegible] and [illegible]

recouped on these earnings. So that I think my thesis is that there is not any double taxation, and any argument for tax credit based on a double tax credit situation just is not there. There is not any.

I think it is a good policy decision to give tax credits, and I would boost it from what it is at the present, if I were king.

COMMISSIONER LEMAN: So it ends up being an indirect device to reduce the incidence of personal inoome tax?

DR. EATON: That is right, that is right. It is just a straight incentive to Canadians to get cracking in their own industries. It is simply that and nothing else.

COMMISSIONER LEMAN: Well, now, if I might turn briefly to another section of your memorandum which deals with the interest that is a deduction in computing corporate profits.

DR. EATON: Yes.

COMMISSIONER LEMAN: I do not want to argue with you at all about the difficulties we would be in in trying to change that now, because it would really be a mammoth job to try to re-arrange everything so that you do not end up with a mess, but on the point itself lets forget about the difficulties.

DR. EATON: Yes.

COMMISSIONER LEMAN: Can you describe for us how you think the corporation, when it contemplates a new investment in plant or machinery will make a

calculation regarding the expected yield to come from this new investment?

DR. EATON: Well, I am certainly not as sophisticated as I should be in this field and I think I would confine myself to a few general statements here.

Generally there is incentive if the yield on capital, no matter what kind it is, is above the borrowing rate; the rate at which that corporation can issue bonds and borrow money. There is an incentive for the corporation quite apart from the tax factor to finance by bonds rather than stock. That is, if there is a margin and they can get some leverage on borrowing and forced savings; that incentive exists there already and would operate for bond financing quite apart from the tax factor. That is about as far as I can go on that. I do not know what is in the minds of people who in practice, such as yourself, sir, are up against difficulties in arranging these things. You have kind of got me in a spot here. I do not know enough about it.

COMMISSIONER LEMAN: Well, what I am trying to get at is this. If the fact that interest is deductible is not in all cases a determining factor, which is your point, would you concede that maybe in a large proportion of cases it adds to the possibility of leverage?

DR. EATON: Yes, I think I would have to agree with that. I think I would. Certainly, where they are getting up to a dangerous position of undesirable

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DR. EATON: Well, I am certainly not as sophisticated as I should be in this field and I think I would confine myself to a few general statements here.

Generally there is incentive if the yield [illegible] is about as far as I can go on that. I do not know [illegible] a good deal. I do not know enough about it.

[illegible]: Well, what I am trying to get at is this. If the fact that interest is deductible is not in all cases a determining factor, which is your point, would you concede that maybe in a large proportion of cases it adds to the possibility of leverage?

DR. EATON: Yes, I think I would have to agree with that. I think I would. Certainly, where they are getting [illegible]

equity debt ratio they would push further in the direction of debt financing because of the interest deduction. I do not think anybody can deny that. I think that I am admitting today here that this is an aspect of a presumption of advantage in equity financing generally quite apart from the tax factor, but that the tax factor, as you suggest, sir, would add to it and might push companies into a dangerous or vulnerable position. I have never heard anybody argue as to why they would like to do this. I have had this thing thrown at me time and again but I have never heard any positive argument really for it apart from this slight danger of inequity debt ratio which, from my point of view, is up to the people themselves to watch and look after. It is not a thing for the government to come to their rescue for by putting in a quite unnatural set of tax laws to protect them from going too heavily into a debt ratio position. Apart from that I have never seen any advantage in it and I do not think it is that important. Certainly it would be troublesome to try to do it.

COMMISSIONER LEMAN: Perhaps it is an over-simplification, but others have expressed this as a problem in the reverse way, and said that a corporation will feel that it has to earn $2 from an investment in order to pay $1 in dividends which are after tax earnings, against having to earn only $1 to service an equivalent debt financing of some investment, is that true?

DR. EATON: I suppose it is, I suppose it is.

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CONGRESSMAN [illegible]: Perhaps it is an over-simplification, but others have expressed this as a problem in this [illegible] way, [illegible] that a corporation will feel that it has to earn $2 from an investment in order to pay $1 in dividends which are after tax earnings, against having to earn only $1 to service an equivalent debt financing of some investment, is that true?

DR. EATON: I suppose it is, I suppose it is.

COMMISSIONER LEMAN: Well, are there any offsetting factors that might creep into the calculations? For instance, corporations in general are not quite like governments, and I think most of them figure that the debt has to be repaid over a period of time, and the fact that you do not expect to have to return the capital from equity financing, at least not over a fixed period of time would have something to do with it?

DR. EATON: Yes.

COMMISSIONER LEMAN: The dollar you need to earn to cover debt has to both yield interest and return of capital?

DR. EATON: That is right.

COMMISSIONER LEMAN: Is that an offsetting factor?

DR. EATON: Yes. I was not just smart enough to pick that up. That is true. I think it is very true, and you may have to make repayment on a concurrent basis on some of it.

COMMISSIONER LEMAN: And generally a corporation in making an investment in say a plant or machinery will make the calculation on a period of time because they feel they cannot look forward too far?

DR. EATON: Yes, that is true.

COMMISSIONER LEMAN: They look at their market say for 10, 15 or 20 years ahead?

DR. EATON: Yes. I felt a little at sea on that question and I did not deal with it very adequately.

COMMISSIONER LEMAN: Well, that is all I have on that section, Mr. Chairman.

COMMISSIONER HARROLD: I believe the next section,Mr. Chairman, is taxation of capital gains. There might be a question or two there. You have taken a considerable number of sections here to deal with the pros and cons of the argument for and against capital gains. I think you covered it very well, as a matter of fact, but you do arrive at the conclusion in which you say that the main case against capital gains tax is its complexity and the problem of trying to collect, I believe.

DR. EATON: That is right.

COMMISSIONER HARROLD: You do have atpage 48, however, an estimate of the revenue that it would produce, which is between $80 million and $100 million per year.

DR. EATON: Yes.

COMMISSIONER HARROLD: How did you arrive at that particular figure?

DR. EATON: I depended on somebody else for that, sir. I think the Tax Foundation has published a guess. That is about all any of us can do. So much will depend upon the content of the law as to what they allow by way of offsets or of losses and so on, and very naturally that figure will vary in pe iods of years, where there is large capital gains being made sometimes and not very much in other times. I think if you had a full offset for losses there would be years in which the yield on your straight income

tax would drop. If you were allowed the offset it would be less than it otherwise would be, so that in certain years you would have a net loss because of capital gains tax rather than a net gain from it. This figure was pulled out of the air by somebody. I had a guess at it myself and came to about that, and I have seen this confirmed in one or two other forms of guessing at it.

COMMISSIONER HARROLD: My final question then is, I am not too sure from your conclusion here whether you feel that there would be very much of an effect on capital flows whether there was a capital gains tax or whether there was not, and I refer you to your last sentence at page 56 in which you say:

"A capital gains tax would similarly cut into the supply of capital available for re-investment."

However, going back to page 49 in paragraphs 123and 124 you say that the effects on the business community of taxing capital gins are quite moderate to say the least.

DR. EATON: I think all I came out with is that it would tax away something in the order of $80 million or $100 million a year which is not very much, I admit, just the same as I have admitted that high personal income tax rates do not take away more than say a couple of hundred million if you take it away completely and put it down to a flat rate. I agree that I am straining a little bit here in saying it would cut into capital, but a little bit is just a

tax would drop. If you were allowed the offset it [illegible] [illegible] of capital gains tax rather than a net gain from it. This figure was pulled out of the air by somebody. I had a guess at it myself and came to about that, and I have seen this confirmed in one or two other forms of guessing at it.

COMMISSIONER [illegible]: My first question then is, I am not too sure from your conclusion here whether you feel that there would be very much of an effect on capital flows whether there was a capital gains tax or whether there was not, and I refer you to your last sentence on page 5 in which you say

"A capital gains tax would similarly cut into the supply of capital available for [illegible]."

However, going back to page 45 in paragraph 1 again you say that the effects on the business community of taxing capital gains are quite moderate to say the least.

MR. [illegible]: I think all I came out with is that it would tax away something in the order of $50 million or $100 million a year which is not very much, I admit, just the same as I have admitted that high personal income tax rates do not take away more than say a couple of hundred million if you take it away completely and put it down to a flat rate. I agree [illegible] would cut into capital, but a little bit is just a

little bit, after all, I think I agree that it is not too significant.

COMMISSIONER HARROLD: It all depends on your view of what a little bit is?

DR. EATON: Yes.

COMMISSIONER HARROLD: As some say, what is a million?

DR. EATON: In looking at this going on year after year, taking this couple of one hundred millions, in five years you get a billion and that is quite a lot of Canadian ownership, if that is where it went.

COMMISSIONER HARROLD: That is about all I have on capital gains unless somebody else has a question.

THE CHAIRMAN: Then we will move to tax incentives at page 56. I gather the general proposition is that you are not too enthusiastic about tax incentives?

DR. EATON: That is correct, sir.

THE CHAIRMAN: I notice in the first place that you refer to certain periods when conditions were such that in effect tax incentives were more or less offset or nullified, so that I suppose in those periods the test might not have been a real test as to the value of these particular incentives?

DR. EATON: That is right.

THE CHAIRMAN: Can you refer to any incident in your knowledge of tax incentives of that kind that were applied at an appropriate time when they could be tested as to their efficacy?

DR. EATON: No, I do not recall any cases of where you could have measured the effects. It is

so difficult to actually measure them. This is the awkward part of this.

Let me go back to one general tax incentive that we have in our legislation which is for natural resources industries. They have a more favourable tax treatment than any other section of the economy, and the mining and oil people will all assert that that lessened burden on them has been a definite encouragement to resources and capital and so on going into the natural resources industries. That is a very broad example, but all you get by way of proof or verification is somebody's sayso. They like it, they think it is good and that it is a help.

As regards the war-time, had there been a depression rather than a boom I think you would have had to admit, as I would admit, that it would have been quite a help to have a volume of funds being poured out in cash for people to spend. I think mainly I am saying that we just have been lucky in what we have done, not being able to see in the future and not guessing right as to when it is appropriate. The same happened with forced savings; the same thing happened with double depreciation and the same thing happened in the Korean show where we took away the depreciation from those who went on spending, and suddenly it was not important any more and they stopped it. Whether it would have been good and had some effect had the period of tightness when they wanted to cut down on that carried on a little longer, I don't know. It might have helped some. I expect it would.

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Partly my conclusions are that you cannot make these things work fast enough. You cannot guess right as to what is going to happen.

Then I come back after all of that and say that if you are operating from corporate tax it does not make much difference anyway by way of a margin of help.

THE CHAIRMAN: You do come to a point in your paper, section 141, where you say:

"In 1962, provisions for tax abatement on profits from increased sales and the incentive for research expenditure may have some real substance."

DR. EATON: Yes, sir.

THE CHAIRMAN: That is one item that you feel is of some importance and might be of some use. On the other hand you point out some difficulties in applying that, almost to the extent that nullifies its usefulness, is that a fair statement?

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Then I come back after all of that and say that if you are operating from corporate tax it does not make much difference anyway in way of a program of help.

THE CHAIRMAN: You [illegible] to a point in your paper, section 1-1, where you say:

The long, continuous and [illegible] increases in profits from increased rates and the incentive for increased expenditure was lost [illegible] real incentive.

[illegible] That all.

THE CHAIRMAN: That is one item that you feel is of some importance and might be of some use. On the other hand you point out some difficulties in applying this, [illegible] to the extent that [illegible] [illegible], is that a fair statement?

DR. EATON: I think it is; I think it is, sir. Of course, I haven't seen the light as to just how they will work this, but I do know from conversations all around the lot that the lawyers, accountants and the tax people themselves in both departments are worrying about this.

I think that it might help some of those in the export trade, but I can't see that it will help a great deal domestically this incentive for increased sales.

We are just trying to best each other, and you may have one company putting a push on and getting ahead of the others, and he will get a bit of tax abatement, and the others will lose business. I think it is a smart move, if it can be made to work, to help the export trade; whereas you cannot give direct incentives, you are not supposed to, but some countries do it against the GATT regulations. It does, I suppose, stop that and it makes fair sense on paper, but really I am rather fearful about it being able to work, or that business men will throw up their hands, and say, "For God's sake, this is impossible," I don't know.

The research incentive is all right, but it is not a short-run thing at all; it will take some years for this to gradually build up to more research expenditure in Canada, and I think that that is all to the good, and I think that that can be handled.

In that field you may get 40 or 50 companies a year applying for the benefits of that piece of legislation. You can handle 40 or 50 companies; you

can practically assign an amount to each company and get by and handle this complex legislation, but for industry as a whole, taking in the increased sales, good heavens, you have an awful lot of taxpayers to handle, and that will be difficult.

COMMISSIONER LEMAN: Is there some danger related to this incentive on the increased sales part? Presumably this would work out when you have excess capacity and want to fill up.

DR. EATON: Yes.

COMMISSIONER LEMAN: Now, at some point your businessman, who has taken advantage of this incentive, does approach a full-out position?

DR. EATON: Yes.

COMMISSIONER LEMAN: For this particular comany, but not necessarily in the industry?

DR. EATON: No.

COMMISSIONER LEMAN: And then he has to have the wisdom to make sure that it would still be wise to invest a little more and have more facilities to keep on increasing sales, and then maybe the incentive disappears and he has made a bad investment?

DR. EATON: Yes.

COMMISSIONER LEMAN: Because presumably this would help him fill out by enabling him, on marginal sales, to go for a slightly lower margin of profit?

DR. EATON: That is right.

COMMISSIONER LEMAN: But it couldn't guide him in future decisions to invest more for the same kind of sales, could it?

DR. EATON: I wouldn't think so, and I will not know what the rest of the industry are doing either. You put your finger on the important point there of the full-out and of what you have got in excess capacity. If you take a cut you can get ahead of the others in the market, and as for the total net effect of that, certainly domestically I don't know that you are much ahead, for the economy as a whole, through having had this.

I don't know whether I should comment on this, but there has been such a flood of requests for incentives by industry. It is terrific; they have felt that they had to do something here even if they are here trying to give it too much. It wouldn't surprise me.

COMMISSIONER GIBSON: You are not suggesting they are just trying this to prove that it doesn't work?

DR. EATON: No, no, I wouldn't say that, but I certainly would say if I were in the department, "Go ahead, it will not work anyway!" It is sort of a defeatist position on that.

THE CHAIRMAN: You do mention an incentive which you refer to as the British form of investment allowances, which you feel is the best so far conceived and it has the advantage of relative simplicity. They simply allow an additional write-off for expenditure on depreciable assets, and that is some percentage more than was spent.

DR. EATON: Yes.

THE CHAIRMAN: But you go on to say that it

offers little financial benefit to the credit-worthy. Would you elaborate on that a bit?

DR. EATON: I think, sir, perhaps I didn't make it too clear, but I think what I meant to say was this; for a speedy write-off, just the advancing of the time of write-off, that that is of no very great financial importance to the credit-worthy, but where you have 150 per cent write-off for an expenditure of 100, that is a real financial advantage.

THE CHAIRMAN: To anybody?

DR. EATON: Yes, to anybody, regardless of the position.

COMMISSIONER LEMAN: It is permanent instead of temporary?

DR. EATON: Yes.

COMMISSIONER LEMAN: A permanent financial advantage?

DR. EATON: That is right, and it is pretty slick. You can be selective if you have courage enough to be selective for industries or courage enough to be selective on areas and districts. It is a quite flexible sort of thing and it is very slick.

As a matter of fact, they are using the same principles here on research expenditure. They have adopted, in effect, the principle of that device which, from my point of view, is easy and simple. I mean, the whole mechanism is set out there; you have depreciable assets and it is just a matter of writing in the capital cost and moving it up and the thing is in motion.

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COMMISSIONE LEMAN: But even the most credit-worthy have to pay something for the credit they get?

DR. EATON: Oh yes!

COMMISSIONE LEMAN: This form of credit, this temporary credit, is free, isn't it?

DR. EATON: Sure. They like it and I don't blame them a bit, but it catches up with them all, that is the unfortunate part of it; it comes a year later and they have all had it and feel pretty badly.

COMMISSIONER BROWN: How about the Swedish system of investment reserves?

DR. EATON: I don't know enough about that, but I think that these reserves, when put in, may only be used at the direction of or at the discretion of the authorities. That is to say, if you put them in you can't just say, "Well, I will now go ahead and use all reserves," I think they are held until you have permission to use them, which isn't quite so hot.

COMMISSIONER BROWN: That is right, but it does answer the other part about it; allowing investment in a contra-cyclical manner to encourage it at times and in specific areas. What is your thinking on this?

DR. EATON: I don't know; I think you might find a time when the government is saying, "O.K., you go ahead now", and industry might not be so inclined. The decision as to when is taken out of their hands, which I think is bad.

The Swedish have done a lot of amazing things

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in the tax field. They had one very good idea at one time, and I think they have withdrawn it, where they left it completely to industry to take depreciation as and when they liked; I think they pulled away from that and this may be a modification of it, trying to put control on.

It was on the books at one time that there be proposed control on municipal and provincial capital expenditure through, not a reserve, but a subsidy by the federal government for a part of that expenditure if you will put the timing upstairs which the federal government culd do, but it never came off, it was too complex and wouldn't work, and couldn't work very well, but I don't know too much about this, and I don't think a lot will come back to this question of the incentive, and assuming that there is a real advantage to Swedish producers, competitors here, I don't know how important that is, that fact that they can take profits up there and re-invest them in capital. How far that puts them in a favourable competitive position, vis-a-vis what they are selling to Canada, I am not sure. I ;have heard it quoted and business men say that the Swedish people fix it all up for you and you can't expect us to compete with that. I don't know how much competitive advantage that gives to them in selling.

COMMISSIONER LEMAN: It is a counter-cyclical measure?

DR. EATON: Yes, it is essentially that.

COMMISSIONER LEMAN: But the businessman is

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COMMISSIONER [illegible]: It is a counter-cyclical measure?

DR. EATON: Yes, it is essentially that.

COMMISSIONER [illegible]: [illegible]

allowed to use the investment reserve whenever he wants to without permission if he is willing to give up the tax advantage?

DR. EATON: Oh sure, sure; he can take it back in and pay tax on it and use it.

THE CHAIRMAN: We will adjourn now for a few moments.

--- Recess.

THE CHAIRMAN: We will now resume. There is just one other question which I have on this point, Dr. Eaton. At paragraph 150 you say:

> "... the question always arises whether it would not have been better for the economy as a whole if the time and money spent on gimmicks would not have been better applied to a great reduction for industry generally."

Your view is that as a general rule it would. I would like to ask you what you would contemplate would be the effects of a general reduction, rate reduction, from this point of view; if industry as a whole had that much more money to spend, where would it really go? Perhaps this would be a guess, but to what extent would it stimulate investment?

DR. EATON: Well, you can get the measure of this by the government's estimates, but I have forgotten what the estimate of the cost of the research expenditure incentive is; the cost of these new

products and new industries in depressed areas, but they will give you a figure of perhaps all of these together. Let us say, for example, that they might add up to $100 million or $150 million; this would be equivalent to a few percentage points drop in the corporate rate which would improve a bit the competitive position for selling abroad and generally leave them a little more money -- perhaps I had better go easy on this thought -- it might leave them a little more money unless at the same time they passed this back to the consumers. I don't know which they will do. Very often they are able to retain the fractional amounts if it is not large enough to cause a passing on to the consumers; they might retain it, in which case they have a little more capital to spend for re-investment.

It is hard to say, sir, where this would fall out in the thing, but generally after having said that I have heard about the corporate tax being passed on, I would still like to see the corporate tax lowered. I think that would be generally good in quite a number of not intangible ways, but in diverse small ways it would help.

I think my conclusion is here that if you say, "Here is $100 million, you will give this for incentives," I think generally you would be just about as far ahead if you took that and made a small rate reduction and make everybody happy instead of paying 90 per cent of the people to do things they would have done in any case. That is usually what happens;

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you pass it around and it helps a little bit.

THE CHAIRMAN: But I take it the reduction wouldn't be passed on?

DR. EATON: It might not be passed on.

COMMISSIONER BROWN: But if your general thesis is correct, since people have lived with this for a year or so, that it would all be passed on and anticipated?

DR. EATON: I think so.

COMMISSIONER BROWN: So, is it possible better that business knows what it will be faced with not only this year but next year?

DR. EATON: Yes, but let us not get ourselves in the position of arguing that if you abolish the whole of the corporate tax it wouldn't help anybody; it would all be passed on. No, generally I am downgrading the bad effects of a corporate tax. Generally I think you do get pretty much in the position of an indirect tax. I have heard Ministers of Finance in the House of Commons, in fact, declare that; that this is about the equivalent of a sales tax on products sole by corporations subject to corporate tax, and generally if you abolish it that is what you would come out with; a gradual reduction of prices, prices lower than they otherwise would be or more services at the same price.

COMMISSIONER LEMAN: Was that the Minister's own theory?

DR. EATON: He said it on his own! Well, I will add to that a little bit, if you like. I don't think, some years ago when this was said, that there

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THE CHAIRMAN: But I take it the reduction wouldn't be passed on?

DR. EATON: It might not be passed on.

COMMISSIONER BROWN: But if your general thesis is correct, since people have lived with this for a year or so, that it would all be passed on and [illegible]

DR. EATON: I think so.

COMMISSIONER BROWN: So, is it possible better that business knows what it will be faced with not only this year but next year?

DR. EATON: Yes, but let us not get ourselves in the position of arguing that if you abolish the whole of the corporate tax it wouldn't help anybody; it would all be passed on. No, generally I am downgrading the bad effects of a corporate tax. Generally I think you do get pretty much in the position of an indirect tax. I have heard Ministers of Finance in the House of Commons, in fact, declare that; that this is about the equivalent of a sales tax on products sole by corporations subject to corporate tax, and generally if you abolish it that is what you would come out with; a gradual reduction of prices, prices lower than they otherwise would be or more services at the same price.

COMMISSIONER LEMAN: Was that the Minister's own theory?

DR. EATON: He said it on his own! Well, I will add to that a little bit, if you like. I don't think, some years ago when this was said, that there

was quite the feeling of certainty that most of the tax was, in fact, passed on. I think this is the belief -- certainly in my own case and in quite a number of others -- and it has grown on us gradually. Ten years ago you couldn't get an economist to argue this; youwouldn't get anywhere near a unanimous view, and they are by no means unanimous on it now.

COMMISSIONER BROWN: How about the three year exemption for new mines?

DR. EATON: Oh, it is a special privilege; it is a special tax concession. I don't know how important it is. A lot of the mining people will say, "Oh, well, there is not much in this anyway". The first two or three years they are not making much or are not getting going; they are not really geared up in too efficient fashion within a year or two and they are just getting something that is not worth very much in the first few years.

I don't think that is entirely a good assessment of it, because in practice through regulations there is a highly artificial definition of what constitutes profit in the first three years. That is, they may, under the ordinary rules, delay taking capital cost allowance at all in this period. That may be passed on. I think that I am right in this; they may delay a write-off for pre-production expenses in this three-year period.

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for this three year period a quite artificial definition of profits; you get a much higher profit figure than ordinary accounting would result in and that has come about through various ways, but that is the way things are and it is much more an advantage, in fact, than ordinary service indications would suggest.

COMMISSIONER BROWN: Would you agree that this is an incentive?

DR. EATON: Oh yes, very much so, and I think that it helps.

COMMISSIONER GIBSON: Don't you think that there are certain times when a special incentive or disincentive may be useful from the standpoint of the economy, thinking of the circumstances of the time and the desire to move things one way or the other? I am thinking, as an example, of the step that was taken during the Korean war not to allow people to charge depreciation on new projects in non-essential industries, and it seems that that worked quite well, because it not only took the pressure off a bit at the time, but it also carried quite a few things over for a couple of years later. You seem to put very little weight on these things, and I am wondering if there are not any in your mind which you think have been pretty useful?

DR. EATON: Well, it may have incurred some capital expenditure, but I do come back to the fact that the actual financial penalty of postponing for a year or two isn't very great. You see, it is just the interest on your tax money, that is all it is,

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COMMISSIONER GIBSON: You don't think it makes too much difference in the timing of expenditures?

DR. EATON: I don't believe it does. I don't know; I haven't enough evidence of that, but I would be surprised if that so-called penalty deterred or delayed very much capital investments. It all sounds like the right thing to do, and I think there would be more businessmen who would delay capital expenditure just on a question of principle rather than the money they could save or the penalty they would run into if they did -- once it was government policy. It amazes me to find so many people in business paying very keen attention to what the government declares is the right thing to do. I am pleased over that; I see a lot of it, and I think the by-product in that direction would be greater than the actual result from hard-headed doing what you like and taking what you like.

COMMISSIONER GIBSON: Perhaps, Mr. Chairman, I could go on and ask a couple of questions about Dr. Eaton's views on fiscal policy.

I must admit I was a little depressed when I read this section of your brief, because we have heard quite a few experts say that monetary policy has grave limitations and that we should not rely too much on it, and you went on in somewhat stronger language to tell us the same thing about fiscal policy, that it really is not very much good.

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much help in stimulating the economy, and you say that maybe the surpluses that we had in the period after the war may have been helpful, but you don't give them very much credit. You suggest that this policy broke down ultimately. I would like to say that it does seem to me we did have surpluses for a long time in an inflationary period which seemed to have some helpful effect in preventing things getting out of hand: would you disagree with this?

DR. EATON: I think what I constantly come back to is that I look at the size of these surpluses and then I compare these few dollars of surpluses -- a few hundred million; make it five hundred million or six hundred million -- and I compare those with the total volume of retail sales and the total volume in capital expenditure and these enormous totals for Gross National Product, and then I say that it is pretty small stuff after all. You say it did help: maybe it did a little bit, but for heaven's sake let us not say that little piece is going to have a terrific effect on the total economy. I think this bothers me as much as anything else in the so-called fiscal measures; that is, the small size of the instruments you have to operate with. You are straining too much to say this is very significant. It is the right thing to do; it is in the right direction; there is no doubt about that.

COMMISSIONER GIBSON: But doesn't it occur at the margin? The difference between a surplus and deficiency is often just a few per cents in business life.

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and during the war when you were 5 per cent short in the demand for cigarettes there were line-ups and when you were 3 per cent long there were all anybody could want. These things did occur at the margin; and therefore it seems legitimte to argue the effect is more important than the mere per cent which the change represents in the Gross National Product.

DR. EATON: Well, I don't agree with you that these small margins of difference are really what you are aiming at. I think you are aiming at what you are looking at. Let us take the period of '45 to '48, up to '49: it is a period in which you are trying to reduce the total volume of expenditure so that, over-all, you will have made some real impression on excess demand.

COMMISSIONER GIBSON: Right.

DR. EATON: You can do that a little bit. I don't care how thin your margins are, but I do say as to total you have not made an awful lot of impression.

COMMISSIONER GIBSON: Suppose the excess demand is only a few per cent: if you had something that represents only one or two per cent of the National Product, that may just knock the steam out of that excess, may it not?

DR. EATON: Some.

COMMISSIONER BROWN: Isn't there also a multiplier effect that has been over-looked? If this extra 100 million wasin the economy, wouldn't it have had a multiplier effect?

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DR. EATON: I never know where to stop when you start talking about multipliers.

COMMISSIONER BROWN: Nobody does, but it is at least more than one.

DR. EATON: If you take a long enough period it is one million. I don't know what period you take. Undoubtedly, if you say on one sale take away a dollar, and that dollar is passed on again and again and again, you will get up to $100 that you had effect on by taking away one.

COMMISSIONER BROWN: That is the margin factor that Mr. Gibson is talking about. My point is that it is a little more than margin.

DR. EATON: There is something in that.

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DR. EATON: No, I won't. Perhaps I underestimate the impact of these things on the total, but my information is to under-value them, or to say that they don't amount to as much as, certainly, most people attach to them -- the value or importance which most people attach to them. I am just the low man on the totem pole on that.

COMMISSIONER GIBSON: Is that a factor we should take into account, that people do take these things seriously and this may give some multiplier and psychological effect which affects real decisions.

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the Central Mortgage people the other day, and one of the things that came out in the discussions was that the actual record in housing starts did suggest that housing had been a bit of a stabilizer. The reason I mention it is because a little contradiction of the statement you make that housing policy is not a stabilizer but tends to be administered as a stimulant only. One of the things that tended to cause this is that the N.H.A. rate is relatively fixed and when money becomes in demand there is less N.H.A. money around and money becomes more plentiful and, because the rate has not changed, there is a good deal more of it around. This seems to have had some anti-cyclical effect in recent years?

DR. EATON: When I say it is a stimulator, I think I am starting from the base that generally their offer for mortgage money has a slight subsidy factor in it. Generally, I think that is true, both in the time of re-payment -- not merely the reate of interest -- but the time of re-payment, and so on, and that you do get in their lending an element of subsidy. I think you are saying this subsidy may be more or less a holder rate until the market goes beyond ---

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DR. EATON: I certainly would not hold myself up as an authority on this; I may be wrong, but it certainly is my impression that there is through the various things -- the guarantee, the term -- an element of subsidy, and that is what I mean by being generally a stimulator, that you vary through the period more or less depending on how they hold themselves. But on balance I would still believe what I said is generally true.

COMMISSIONER GIBSON: Thank you.

COMMISSIONER LEMAN: Instead of talking about the effectiveness of fiscal policy in the absolute, why don't we talk about it a little bit in relative terms. You seem to be fairly optimistic that monetary policy has effectiveness as against fiscal policy. Let us talk about them in relation to each other: do you really feel monetary policy, which people also tell us operates at the margin only, is more effective or less effective than would be fiscal measures?

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COMMISSIONER GIBSON: On this problem of timing and the obvious difficulties of changing fiscal policy quickly, what do you think of the idea of giving the executive -- the cabinet minister -- certain discretionary powers to change certain sales taxes within certain planned limits?

DR. EATON: Yes, I think so; I would be in favour of that. But, take the next step and ask me where you would do it if you had the power. That is the difficult question to answer.

COMMISSIONER GIBSON: But this is the problem the monetary authorities are faced with.

DR. EATON: Meaning they cannot move on their own?

COMMISSIONER GIBSON: Yes, but it is quite difficult to know when to move.

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COMMISSIONER GIBSON: You think there is some sense in this approach, that there should be some discretionary power to change certain types of taxes?

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COMMISSIONER LEMAN: Dr. Eaton, in paragraph 184 you seem to make the point that fiscal measures as counter-cyclical measure have very unequal effects. If you start varying, for instance, the corporate taxes, you would affect different people differently. Monetary policy action for some purposes also has some unequal effects, doesn't it?

DR. EATON: Yes, but monetary policy does not take money out of your hide and turn it into the treasury so that you never get it back. You may be slowed down and not make a certain expenditure, but what I am talking about here is jumping the corporate tax up 10 per cent or something and taking that money

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COMMISSIONER LEMAN: Well, for some operations, if you take away their credit you take away practically as much as if you took away their money, don't you?

DR. EATON: Well, no; you stop them just in their tracks. They decide not this year, perhaps next year: "We can borrow more cheaply another year." But that is frustrating, perhaps, and frustrating their plans for what they would otherwise do; but you are not taking money out of their corporate treasury and turning it into the government.

COMMISSIONER GIBSON: If they have assets like government bonds, monetary policy may very well wh ttle away those assets?

DR. EATON: But you wait a while and it will come back.

COMMISSIONER BROWN: Maybe it will have the delayed effect you are looking for.

DR. EATON: Yes.

COMMISSIONER BROWN: You made the comment that if sales taxes were changed suddenly you would ruin a lot of people. What if you change the method of application of sales tax now that the provincial governments have set up machinery to put it on at the retail level? If they were all on at the retail level you could make the changes without the secondary

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DR. EATON: Yes.

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effects you talk about as far as retail and wholesale is concerned?

DR. EATON: That is correct; I would agree with that. It could be an instrument that would be practicable to use if you had all retail sales taxes, including tobacco and liquor, at the retail level. It is pretty messy.

I worked on this some years ago to see if this was a sort of practical thing. If you got all the provinces with provincial sales taxes and then have a collection of the federal rate downstairs, and if you had a tight enough enforcement to take care of the small outlets all over the country, it would probably work. We may come to that one day.

COMMISSIONER BROWN: This would give you an elastic tax structure that could be changed to meet short term policies?

DR. EATON: Yes, you could change the future views in the total that was being collected. I do not suppose you would expect the provinces to go along with that sort of thing you were doing, but that is in the future.

There again I still come back to this relatively small amount that would be changing; the total purchasing power of these changes down even at that level, unless you put in enormous amounts; enormous changes that would wipe out the whole thing for a period. You could get into fairly substantial sums. I think sales tax now is close to a billion, or something of that order, which is quite a lot of money. If you wanted to abolish it completely for a whole year or in periods when things were slow it might help it, yes.

COMMISSIONER GIBSON: When you are speaking of the provinces, would you be prepared to make any comment about the co-ordination of federal-provincial spending and tax policies as they relate to the flow of savings in the country? That is something you have not

I worked on this some years ago to see if this was a sort of practical thing. If you got all the provinces with provincial sales taxes and then have a collection of the federal rate downstairs, and if you had a tight enough enforcement to take care of the small outlets all over the country, it would probably work. We may come to that one day.

COMMISSIONER BROWN: This would give you an elastic tax structure that could be changed to meet short term policies?

DR. EATON: Yes, you could change the future views in the total that was being collected. I do not suppose you would expect the provinces to go along with that sort of thing you were doing, but that is in the [illegible]

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dealt with in your memorandum. I realize it is an enormous subject, but if there is something you would like to say about it we would be very glad to hear it.

DR. EATON: Oh, I don't know. No, I do not think I can say much about this.

I will make this one comment, I think the main volume of unused tax capacity is with the provinces rather than with the federal government, and the thing that flows from that generalization is that this pouring of federal money down to the provinces is bad from the point of view of the tax structure as a whole. With our rates as high as they are at the federal level; 50 per cent to 52 per cent tax, and the high tax on liquor, tobacco and so on, you could broaden out your sales tax base, but for the rates and rate structure I would think there is more scope for raising tax now much easier with the provinces than there is today with the federal government.

THE CHAIRMAN: Would you specify what you mean? That is a new view.

DR. EATON: I would specify that. I would say in the province of Ontario they could have put on a higher sales tax rather than expect money to be handed down from the federal government. I would say the same thing for every other province.

THE CHAIRMAN: Money is not handed down from the federal government. The federal government instead of withdrawing a certain number of points from a certain tax field simply continued to tax in this field.

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THE CHAIRMAN: Money is not handed down from the federal government. The federal government instead of withdrawing a certain number of points from a certain tax field simply continued to tax in this field.

DR. EATON: Yes, sir.

THE CHAIRMAN: And spread the money among the provinces with the purpose of helping some province which the federal government thought needed it. If the federal government had withdrawn from the corporation tax field the same number of points, period, and let the provinces increase theirs, if they wanted to, that would have been perfectly satisfactory, but the federal government is not giving anything to anybody.

DR. EATON: Well, they have run into a deficit clost to $3 billion in the amount handed out to the provinces; by that amount or nearly that amount, and some day or somehow federal taxes are going up enough to recapture that and balance the budget. I am saying here if you put that additional burden which should go on and has not yet on the federal structure, it would be easier downstairs.

THE CHAIRMAN: The provinces are also running at a deficit.

DR. EATON: Well, I think that all I am saying sir, is that there is more scope --

THE CHAIRMAN: Where do they get the money?

DR. EATON: That is right. Both sides have to have more money. All I am saying is that without distortion of the tax system it can be easier obtained at the provincial level in all provinces. I just mentioned Ontario as an example.

THE CHAIRMAN: Oh, I am not sensitive.

COMMISSIONER BROWN: Have you looked at one

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particular feature which does effect investment, and that is the incidence of succession duties in the provinces of Ontario and Quebec applied on security holdings of Canadians living in other provinces? This comes about when there is not a transfer office for corporations in these other provinces, and at the grass-roots level this does influence investment decisions by individuals.

DR. EATON: Let me repeat this. You are saying that succession duties in Quebec and Ontario; they retain their own and collect their own and that they levy a tax on the property passing in the form of shares when the corporation has a transfer office in Ontario and Quebec?

COMMISSIONER BROWN: And not outside.

DR. EATON: And not ouside, and the people in another province will get stuck with inheritance tax if they die owning shares in Ontario and Quebec?

COMMISSIONER BROWN: Against which there is an offset granted by estates tax, but in many cases it is not sufficient, and in any event you have legal problems and so forth to go through.

DR. EATON: Yes, it is a troublesome thing. Well, look, that can be taken care of. That whole problem can be taken care of so simply, if the person in the other province would set himself up a little personal corporation which never dies.

COMMISSIONER BROWN: That is what they all do. That is what they have to do.

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COMMISSIONER BROWN: But this is not always practical for the small person?

DR. EATON: Oh, fairly practical. If you have got enough money to invest in shares, a few hundred dollars will fix you up with a personal corporation.

COMMISSIONER BROWN: That is all right, I have one.

DR. EATON: So I would not blow that up into a real problem here; investment here in this field.

COMMISSIONER GIBSON: I have one more general question, Dr. Eaton. You state in your memorandum that it is desirable to have more savings in Canada. This is a view that is very widely expressed, and it is obvious that it is desirable. You also make it clear thatyou think it would be desirable to have larger Canadian ownership of Canadian industry. Now, to sum up, what in the tax area do you think would help this process most? You have said in a number of places that personal income tax is too high, but you are not sure that is very important. You say that corporate tax is too high, but it is passed on. If you were asked, as I am asking you, what would you do if you could change these things with a view to increasing savings in Canada and with a particular view to increasing Canadian ownership of Canadian businesses and resources, what would you do then?

DR. EATON: I do not know what I would do.

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emphasis, that is what I mean?

DR. EATON: I do not know. I have mentioned tax credits here as a silly little thing. You could help with it a little bit. I think mainly this will have to come gradually, and I think it will come mainly through corporate acquisitions rather than anything you do by way of the individual. That is, Canadian corporations with upstairs money acquiring Canadian control, but we are in an awful position in this country, paralleling the United States with their volume and eye for bargains. It is an awful problem. I do not know what the answer is, I just do not. I just know it is not very practical to put pretty harsh penalties on foreign ownership. You can do it. There is no doubt about it. With your tax position you can change withholding rates and interest on dividends, and you can create real bargains very quickly with your tax structure. But, good heavens, if you have not got enough money to take that up, what happens? You may get a few hundred millions but where you have got something in the order of 16 or 18 billions of United States foreign ownership in Canada and you start putting taxes on and making a real impact on that you won't get buyers. It will have to be a slow and gradual process of creating bargains which you can do quite easily through your tax system. There is an instrument, but it is a very harsh one and it is very uncertain how the effect of that might work out. Just as soon as the United States gets the idea they are putting penalties

on that they will pull out and you have a crisis on your hands. This is an awful delicate problem. I think we are in a position in this country that is particularly difficult; that is in retaining ownership with a relatively small amount of capital accumulation being alongside a border where there is so much venturesome money and individuals looking for bargains and good business prospects. I do not know. I have not got any other suggestions. I just mention that you can create bargains quite easily through the tax system.

COMMISSIONER GIBSON: Well, do you think if the personal income tax was graduated to a much lower top that you might get the sort of marginal effect increasing savings?

DR. EATON: No, I do not think so. Look, we sit here and say, bring the rate down to 40 per cent. What have you achieved; $40 odd million. Well, shucks, that is not anything in comparison with the sort of problem we are looking at here in respect of billions and billions. I do not know. It worries me. It bothers me but I do not know what you are going to do about it.

COMMISSIONER GIBSON: If you are going to change it will be a very long and gradual process. You will not get billions overnight at all.

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THE CHAIRMAN: There is just one question I want to raise in respect of the section on death duties. Apparently you think that the one acute problem arises in the case of a family business that is worth $1 to $2 million, or thereabouts, but it seems to me that you are regarding the business as being owned by one proprietor.

DR. EATON: Pretty much. I have made that assumption.

THE CHAIRMAN: But isn't that a family business, and if the ownership is distributed among the members of the family then the problem becomes less acute, does it not?

DR. EATON: Well ---

THE CHAIRMAN: Because they do not all die at once, unless they are on the same airplane or something of that kind.

DR. EATON: Yes, I see what you mean. No, I must say I had assumed pretty much a one man ownership.

THE CHAIRMAN: Who intends to pass it on after his death?

DR. EATON: That is right.

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THE CHAIRMAN: Yes, but it narrows it down quite a bit?

DR. EATON: Yes, it does.

THE CHAIRMAN: There are always inequities of some kind, but this problem can be overcome if a man thought it out?

DR. EATON: That is right.

THE CHAIRMAN: And set up some arrangement, corporate or otherwise, which would ease the position?

DR. EATON: Yes, that is right.

THE CHAIRMAN: Outside of that one particular type of case you do not think that death duties are too troublesome?

DR. EATON: Not up to a million or so.

I would simplify this. I would assume that it is fairly easy. Say a business is of a type where you can get mortgage money on assets. That might not always be too easy. You may not have the type of assets that lend themselves easily to mortgage money, but generally I think it is a fairly reasonable basis of assumption that this is where you can get relief, and it makes it awkward from the point of view of legislation to have to bring in the big type of estate in order to get relief. It is a pretty impossible sort of relief to ask for in a House of Commons.

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COMMISSIONER BROWN: But throughout you have made the assumption that this is being done by somebody who knows what he is doing; he arranges his life insurance and dividends, and so on, so that they can get the rest out of the undistributed surplus by paying the 15 per cent; paying the penalty?

DR. EATON: That is right.

COMMISSIONER BROWN: But does not the situation really arise and the problem you discussed in paragraph 199 where you say:

"Some discussion of this problem implies that the tax somehow favours a take-over by foreigners. There is nothing in this."

DR. EATON: Yes.

COMMISSIONER BROWN: I have had accountants tell me quite frequently that a foreign corporation can afford to pay a higher price for the surplus of a company which has not foreseen this problem and has not put itself in that position, than can a Canadian corporation, and that this is why a lot of these companies are sold out to foreigners.

DR. EATON: Well, I do not know whether I would go along with that or not. Well, the purchaser who plans to run the business, he can create a tax-free surplus through the 15 per cent depending upon the part that has accumulated; when it was accumulated and dividends went out to take care of the other half. A United States company would pay likewise the 15 per cent in the winding up of the company and the distribution of the surplus.

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COMMISSIONER LEMAN: If we might pass on, Dr. Eaton, to your remarks about credit unions, as I gather, you say: let us treat them as co-operatives; let us not make an exception, and by removing the special treatments we are not going to do them any harm anyway. That is about your position?

DR. EATON: That is right.

COMMISSIONER LEMAN: Would you feel that there is one thing that would have to be paid attention to, and this is the fact that they do not all finance the same way province by province? There are some that are much more share financing and others much more savings or deposits financing, so that the incidence of the change could be slightly different, couldn't it?

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COMMISSIONER LEMAN: It would have to be declared deductible?

DR. EATON: That is right, it would have to come out by the dividend rule in order to qualify for tax credit; it couldn't go out as interest on savings -- it could go out, but it wouldn't get a tax credit.

COMMISSIONER LEMAN: One of your arguments is that there is no reason why any particular class of institutions should be able, under our tax system, to build up tax-free reserves?

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COMMISSIONER LEMAN: Can you think of any others besides these?

DR. EATON: Yes, the banks have the privilege of a deduction from income for reserves under the supervision of the Minister of Finance. I forgot to mention that; I said no others did have this privilege.

COMMISSIONE LEMAN: No others?

DR. EATON: I don't know of any others that have the right to deduction from income for reserves.

COMMISSIONER LEMAN: Well, there were some mortgage and loan companies that came before us and made a recommendation that they be given a little more leeway.

DR. EATON: That is right. I remember now a few years ago the mortgages of certain classes of companies -- trust and loan companies I think they were -- they were allowed to set aside each year a small amount building up to -- I have forgotten what the percentage is -- 2½ per cent of the value of mortgages, something like that, as an accumulative build-up. I had forgotten about this, that is right.

COMMISSIONER LEMAN: In general do you think that is a bad principle; would you be against such reserves for tax purposes?

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banks and credit unions through having money on deposit; that I think was the original argument for a tax-free reserve, and I think for the banks it was so that there would be a reserve through which they would not have to show to the public the large volume of loans in a particular year that might start; perhaps it was something of that sort. That is the same basis for arguing for reserves, but generally for industry that is not the case. I don't think there is basis enough in the credit unions for the right to a tax-free reserve because their deposits are all notice deposits and I don't think that they have any large volume of straight demand deposits as the banks have and they are not as vulnerable as the banks are to panic.

COMMISSIONER LEMAN: These things end up as a form of incentive again?

DR. EATON: Oh, incentive is just a gift; I don't think they are induced to do things because of this tax-free reserve.

COMMISSIONER LEMAN: I wasn't thinking of credit unions here, but in the case of the mortgage and loan companies it might be a form of incentive?

DR. EATON: They could invest in mortgages rather than in other directions. It might be a bit, but it is not important; it is not large, not important.

COMMISSIONER LEMAN: I have a question here which is not very relevant to what we have been discussing, but since Mr. Gibson had told you that he had been a little depressed by some of your views

banks and credit unions through having money on deposit; that I think was the original argument for a tax-free reserve, and I think for the banks it was so that there would be a reserve through which they would not have to show to the public the large volume of loans in a particular year that might start; perhaps it was something of that sort. That is the same basis for arguing for reserves, but generally for industry that is not the case. I don't think there is basis enough in the credit unions for the right to a tax-free reserve because their deposits are all notice deposits and I don't think that they have any large volume of straight demand deposits as the banks have and they are not as vulnerable as the banks are to panic.

COMMISSIONER LEMAN: These things end up as a form of incentive again?

DR. EATON: Oh, incentive is just a gift; I don't think they are induced to do things because of this tax-free reserve.

COMMISSIONER LEMAN: I wasn't thinking of credit unions here, but in the case of the mortgage and loan companies it might be a form of incentive?

DR. EATON: They could invest in mortgages rather than in other directions. It might be a bit, but it is not important; it is not large, not important.

COMMISSIONER LEMAN: I have a question here which is not very relevant to what we have been discussing, but since Mr. Gibson had told you that he had been a little depressed by some of your views

about what can be done about things, there is one argument which you may make in paragraph 187 that rather depresses me, and that is that you say that it seems practically impossible in a lot of circumstances to judge whether we are in a cost-push or demand-pull, and if we don't know that we don't know very much, do we?

DR. EATON: No.

COMMISSIONER LEMAN: You have answered me!

THE CHAIRMAN: This concludes the discussion.

DR. EATON: Thank you, sir.

THE CHAIRMAN: We appreciate very much the paper that you have prepared for us and the discussion which has ensued.

DR. EATON: Thank you very much.

THE CHAIRMAN: We will adjourn now until 2 o'clock this afternoon when we shall hear the brief of the Canadian Chamber of Commerce.

--- Luncheon Adjournment.

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COMMISSIONER [illegible]: You have depressed me!

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--- Luncheon Adjournment.

--- Upon resuming at 2 P.M.

SUBMISSION OF

THE CANADIAN CHAMBER OF COMMERCE

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APPEARANCES

Mr. George Keeping
Mr. J. G. Crean
Mr. W. J. McNally
Mr. H. H. Edmison
Mr. J. Strathy
Mr. W. A. S. Case
Mr. D. Kerlin
Mr. W. J. Sheridan

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THE CHAIRMAN: We will now come to order and we will consider the brief of The Canadian Chamber of Commerce, and, Mr. Keeping, you are the prime spokesman for the organization and we would appreciate it if you would introduce your colleagues.

MR. KEEPING: May I just make a few very short remarks first?

THE CHAIRMAN: Certainly.

MR. KEEPING: Mr. Chairman and gentlemen, the executive council of the Canadian Chamber of Commerce is very grateful for this opportunity to express its views to this Commission.

You have received copies of the brief in advance, and the brief is based upon the democratically approved principles and policies of the Canadian Chamber of Commerce and is submitted by the executive council, which is appointed by the National Board of Directors, the governing body of the Chamber, to carry on the ordinary business of the Chamber during the interim between the meetings of the Board.

The Canadian Chamber of Commerce, as you probably know, is a voluntary federation of some 850 Chambers of Commerce and Boards of Trade throughout the country. 75 per cent of that 850 are members of Chambers established in communities with populations of 5,000 or less.

The Ad Hoc Committee, which was set up by the executive council to prepare this submission, has taken into account and has endeavoured to present as far as possible the views of the small businessman.

You will note that the brief has been signed by Mr. F. W. Bradshaw, who was the chairman of the executive council at the time of the preparation of the submission. We have since had an annual meeting, and I am now the holder of that position.

My delegation is composed of Mr. W.A.S. Case, who is third from my right, and who is the provincial director from New Brunswick. Mr. J. G. Crean, a past president of the Canadian Chamber of Commerce, and chairman of the ad hoc committee charged with preparing the submission,is on my right. Mr. J.G. Strathy, co-chairman of the Public Finance and Taxation

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Committee is next door but one to me on the left. Mr. H. H. Edmison, a member of the ad hoc committee, is next door but one to me on the right, and Mr. Donald Kerlin is also a member of that committee and is on the far left. Also on my extreme right is Mr. W. J. Sheridan, assistant general manager of the Canadian Chamber of Commerce, and on my left Mr. W. J. McNally, manager of the Policy Department of the Canadian Chamber of Commerce.

Our submission is founded on the Chamber's declaration on the Freedom of Enterprise which is attached as an appendix to the submission. In particular, the executive council believes that the economy will be best served by a capital market that is free, competitive and viable. The submission expresses a view that the market functions immeasurably better than any system based on governmental control of the way the nation's savings are put to work. It believes that the role of government should be one of encouraging the system to function more smoothly.

At page 3 and following there is summarized the recommendations that have been made in the submission. Since you have had the brief in advance, I don't feel that you would want me to subject you to a reading of it, although I would be quite glad to do so should you wish it.

THE CHAIRMAN: It is not generally done.

MR. KEEPING: I am very glad not to have to do it, sir, and therefore --

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MR. KEEPING: --- with these opening words we are in your hands to pose any questions you may wish to. I would like to say that I, in my capacity as chairman of executive council, do not hold myself out in any way as an expert in this field, and I would hope that you would permit other members of the delegation to take part in it.

THE CHAIRMAN: Certainly. We will proceed, then, with the discussion.

COMMISSIONER GIBSON: I will ask a few general questions. I would like to ask a few questions about your views on the capital market.

You make a number of general statements as to the sort of capital market we should have. Mr. Keeping, you just read a statement that the executive council believes that the economy will best be served by a capital market that is free, competitive and viable. Later you say that the executive council believes that the present deficiencies in the capital market can be remedied so as to make it function even more efficiently than it does now. Later on page 11 you refer to gaps in the capital market, and you say:

> " ... that when government intervenes in the functioning of the financial system, it should do so with the objective of improving the functioning of that system and filling gaps in it that need to be filled and are not being filled by the private sector."

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> "... that when government intervenes in the functioning of the financial system, it should do so with the objective of improving the functioning of that system and filling gaps in it that need to be filled and are not being filled by the private sector."

Then at page 13 you go on to say that the government shouldn't go too far in this area; that they tend to do little more than fill the gaps at times, and that private arrangements are the most desirable.

I wonder if you would elaborate a little on what are the deficiencies in the capital market and how you think you can make it work better?

MR. STRATHY: Mr. Commissioner, I think what we have really ended up by saying is that these gaps are now being possibly filled to a better extent by private enterprise corporations than was the case earlier.

For example, RoyNat Corporation and the Canadian Enterprise Development Corporation Limited, which has been a development -- the latter one particularly -- which perhaps hasn't started operating yet, but it is in a development which has acted quite reasonably and we feel that these are the kind of private enterprise organizations for which there has long been a need and which should provide a very useful function in the capital market.

In conjunction with that, we are talking about the Crown corporations in this area, and, as we have said in our brief, we feel that they should fill gaps that are not always filled by private enterprise, but not to continue operating on a very vigorous basis if a private corporation has come in subsequently and appears to be starting to or filling these gaps.

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COMMISSIONER GIBSON: Are you suggesting that a Government organization should be willing to fill a gap on better terms than a private institution would?

MR. KEEPING: Yes, that is right.

COMMISSIONER GIBSON: We have heard, for example, some suggestions that the Industrial Development Bank is too active competing with some private businesses. What are the criteria for competition between a government company and private business? What is reasonable and what is not?

MR. KEEPING: Perhaps Mr. Strathy would answer that question.

MR. STRATHY: One aid the government institutions have had is that they have been able to acquire money for their funds for their development programmes at a much lower cost than would be available to a private corporation which has to go into the money market and pay the going rates. That is a good thing if these gaps have to be filled, but this kind of corporation in a sense is being subsidized if the gap is filled by a private enterprise corporation.

COMMISSIONER GIBSON: When you are speaking of gaps you refer specifically to two companies in the area of, particularly, equity-capitalized new industries. You think there is a gap that needs filling. Are there any other areas that you feel are not adequately serviced at the present time?

MR. STRATHY: I suppose it is perfectly fair

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I should think that is the area which needs to be studied and where there is a need for capital corporations like the Industrial Development Bank or within newly-formed organizations, which I am not sure we are entirely familiar with as to how they are going to function. Presumably they are going to lend money and also put up equity money. If they do do that it seems to me they could apply those talents both to companies that have been in operation for some considerable time and to new companies.

There would still be lots of companies outside the workings of these private corporations, so presumably there would still be gaps.

COMMISSIONER GIBSON: But there is no other particular one you want to emphasize at this time?

MR. EDMISON: Perhaps one should add, Mr. Commissioner, that there are always going to be gaps in a general sense that will develop. For instance, one would be in the capital social area, and in other types of, shall we say, private enterprise capital. I do not think that what has been suggested here in the social capital area where, as we all know,

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the Central Mortgage and Housing Corporation has been useful and effective in helping to provide funds in that area in co-operation with other bodies such as municipalities and provinces. I think what was intended to be stressed here is that in the areas which are considered to be more in the private sector, these gaps can perhaps be more properly filled by private companies.

The Chamber welcomes the introduction of these new corporate bodies and hopes there will be more. This is without prejudice, of course, I think in expressing a personal opinion of the activities of the Industrial Development Bank, which moved into a specialized area in their field.

COMMISSIONER GIBSON: Have you any views about the supply of capital to business in Canada?

MR. EDMISON: I would think, Mr. Commissioner, one has to look at it at the level of the over-all capital investment and the policy to muster the savings to meet that investment. For example, in the current year the over-all estimate of capital formation in Canada is 8.7 billion dollars. In all likelihood the savings are not available even in this country to meet such a level of capital outlay without calling, let us say, on some capital or savings from outside the country, which of course has been our pattern for quite a number of years. You have to think in terms of investment and savings as to the level of the capital programmes that are envisaged both public and private, and the savings that are available to meet

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them at any given time.

COMMISSIONER GIBSON: I take it you are not content with the present level of savings?

MR. EDMISON: No, I would not think so.

COMMISSIONER GIBSON: I take it the Chamber does not have any strong view on the import of capital? You say that the import of capital should not be discriminated against.

MR. EDMISON: That is right.

COMMISSIONER GIBSON: That is the only statement I see in the brief on that.

MR. EDMISON: I think it is a recognition of the fact that we have for quite a long time relied on foreign savings to finance part of our capital programme, and we cannot envisage any change in that pattern.

COMMISSIONER GIBSON: With respect to your recommendations, your first recommendation is:

> "That the role of government be to encourage the private competitive economic system to function more smoothly."

Would you elaborate a little bit on this?

MR. STRATHY: I think we get down to the area of government debt creation and the function of the financial community. Is that the area in which perhaps your question is related?

COMMISSIONER GIBSON: Yes.

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this matter of raising capital there has to be the closest co-ordination between the money managers -- the Bank of Canada and the Department of Finance -- and the financial community to ensure that the vehicle which is put out for the public is acceptable to the public. In my view, and perhaps it is a personal view because of the industry I am connected with, this liaison has very considerably improved in late months, perhaps since the development of the crises in June.

I think there is very real improvement. The fact that the Bank of Canada and the Department of Finance are calling down to Ottawa experts who are going to visit in the main financial centres and feel the pulse, seems to me, is something that is productive of the best results in raising new capital, at least in the Federal scene. We in the Chamber of Commerce feel that this could well be formulized perhaps now or at a later date. If I could draw an analogy with the provinces: in this particular area certain provinces for years have appointed fiscal agents or they have sought the counsel of all the money raisers to guide them in drawing up and designing the best medium to raise their financial requirements. Now, the Federal Government naturally cannot appoint fiscal agents, but it seems to me they could take a leaf out of the pattern in the United States whereby leading financial men in the community are on call from Washington, the Federal Reserve, and do go down to Washington from time to time and are taken into the confidence of the authorities in Washington.

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I think from that, sound advice is obtained and practical results achieved. Of course, the two countries are not similar in all respects, but the Chamber feels that this kind of a development is in the best interests of this matter of raising capital.

We want to make the point that perhaps stemming from agitations of this kind, this development is now coming along very nicely and much more satisfactorily than it used to. If I may continue with my remarks, in the 1958 conversion loan, for example, I would say at this time -- and this is perhaps citing an example -- the investment fraternity, and perhaps the institutions too, were faced with a fait accompli and were called down to Ottawa and closeted with the authorities and told that 50 per cent or 60 per cent of the outstanding government loans would be refunded in that vast refunding at that time.

Well, perhaps because of other factors that action was not all that successful. It was too big and took too long, and of course money markets changed during the interim. But it might have been very much more successful on a smaller basis, which I say might have been the advice of the experts in the financial area where those securities had to be sold.

COMMISSIONER GIBSON: You are in effect saying the government should get good advice and sound out expert groups on major matters of finance policy. Your first recommendation reads:

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encourage the private competitive economic system to function more smoothly."

To go a little further, I just wondered if you could give us a general idea of what you mean by that? Does that mean that the Canadian Chamber of Commerce is in favour of a basically anti-cyclical monetary and fiscal policy?

MR. KEEPING: No, I do not think it necessarily indicates that. This is a general recommendation which is a preface, really, to most of our other recommendations. It reflects an appreciation by us that government has a role to play in the economy, something which perhaps was not recognized to the same extent some 20 or 30 years ago. In these days of high competition in the trading world I think we recognize that government has a role to set the climate for the economy, and I think that requires a close form of co-ordination of the various government departments, such as the Department of Finance and the Department of Trade and Commerce, and so forth. The government has this role of setting the climate to enable business under the private enterprise system to make the progress it should make. This is a general sort of statement without bearing in mind any specific things such as anti-cyclical budgeting, and so on. It is merely a recognition by us that the government has a greater role to play than it has perhaps had in the past.

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word "planning" because I do not mean it in the form of economic planning in the socialist sense, but to give thought to providing a suitable climate for business to flourish, and in our opinion that necessitates a more energetic degree of co-ordination within the government.

COMMISSIONER GIBSON: Yes; but would not a reasonable policy for providing a favourable economic climate involve combating depression on the one hand and inflation on the other hand?

MR. KEEPING: Oh, certainly. I was not denying that. I wanted to point out that the terms of that recommendation were in general terms. I agree with you.

MR. EDMISON: Perhaps Commissioner Gibson is pressing on, to some extent, into recommendation No. 2, dealing with co-ordination.

COMISSIONER GIBSON: That is true.

MR. EDMISON: You could, of course, have a set of circumstances develop where the fiscal policy of the government at a given time -- and we are not saying inappropriately -- has run into substantial deficits and, in the financing of these deficits through the debt management operations, they have in effect preempted the savings for that purpose, and it is quite conceivable that unless this operation were conducted with great skill it could have some dislocating effects or might not leave enough room for financing not only in the private sector but in other levels of the government.

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MR. EDMISON: You could, of course, have a set of circumstances develop where the fiscal policy of the government at a given time -- and we are not saying inappropriately -- has run into substantial deficits and, in the financing of these deficits through the debt management operations, they have in effect preempted the savings for that purpose, and it is quite conceivable that unless this operation [illegible] some dislocating effects or might not leave enough room for financing not only in the private sector but in other levels of the government.

We are simply saying in that particular respect co-ordination is vital, and one could of course use the same kind of argument in respect to the exchange rate policy, which must be harmonious with the monetary policy, and the role that the commercial policy should play, and so on. But there are a great number of examples to show how important co-ordination is.

COMMISSIONER GIBSON: Are there any particular ways you think this should be done, or areas where it could be improved? Mr. Strathy mentioned one when he talked about financial plans.

MR. EDMISON: You mean suggestions with respect to personnel?

COMMISSIONER GIBSON: Well, how government policies could be better co-ordinated? This is obviously a good idea. Have you any specific thoughts?

MR. EDMISON: I think it is specific in recommendation No. 3 that the government, in relation to monetary policy, on which there has been some confusion or concern in the past, has to be responsible for it, at least at a given time, and it must be recognized that government is responsible not only for fiscal policy but for exchange rate policy and debt management policy, and also responsible in the final analysis for monetary policy and must make it possible at least for that kind of co-ordination. If you have not got that, then obviously you have not got co-ordination or you are in great danger of having some schizophrenia in the area.

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COMMISSIONER GIBSON: In other words, you would like to define the responsibility more clearly?

MR. EDMISON: I think that is the intent of recommendation No. 3.

COMMISSIONER GIBSON: Before we go on to deal with recommendation No. 3, in addition to the things you mentioned there are other areas of economic policy. I wonder about housing, for example. Do you think the housing policy is near enough to the monetary, debt and exchange policies? We have listened to representatives of the Central Mortgage and Housing Corporation and I got the impression that they felt they were doing a housing job and are not part of the anti-cyclical apparatus. But I would think it does affect them to some extent.

MR. EDMISON: In practice it has, has it not, partly because of their rate structure.

COMMISSIONER GIBSON: Yes. Do you think in terms of a rather broader co-ordination than simply monetary, fiscal and exchange policies?

MR. KEEPING: I think so, a broader co-ordination with trade and commerce in particular. We have more or less confined this to the monetary and fiscal and financial aspects as a matter before this Commission.

COMMISSIONER GIBSON: The trouble is that things like housing involve interest rate and you may get into the same area.

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COMMISSIONER GIBSON: The trouble is that things like housing involve interest rate and you may get into the same area.

MR. KEEPING : Yes.

COMMISSIONER GIBSON: Moving on to recommendation No. 3, it reads:

"That the Bank of Canada Act be amended so as to give the government the authority to issue broad directives to the Bank of Canada on over-all monetary policy."

How would these directives be given, when there is a difference between the Bank of Canada and the Minister of Finance, or would they be given regularly as a guide to operations of the Central Bank? What is your thinking?

MR. KEEPING: My own view is that they would be given as guides to policy. Obviously, the Bank of Canada is contemplated as being there to carry out the day-to-day business, and it should not be interfered with so far as that is concerned, but it may be necessary from time to time -- and probably will -- for the government to give it direction to see that the monetary policy it is carrying out is in keeping with the fiscal and commercial policy of the government. However, I do not think we had in mind any regular directives being issued once a month or once a week, and so on. This is merely a general recommendation that the government ensure that the monetary policy being carried out by the Bank of Canada is in line and is co-ordinated with the government's fiscal and commercial policy.

COMMISSIONER GIBSON: But you would see these directives as directives that might, in fact, be issued from time to time, rather than this being a power held in reserve by the government in case there was a fundamental difference in policies?

MR. KEEPING: Well ---

COMMISSIONER GIBSON: You see, some people have suggested that there should be directives issued at regular intervals telling the Bank of Canada the direction in which it should move. Others have suggested that there should be only a power of directive, which power is to be exercised only when there is a fundamental difference.

MR. CREAN: Mr. Commissioner Gibson, during

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the discussion we had when we were putting together this brief one thing came up, namely, that in years gone by, as I am sure you are aware, the separation of monetary policy from the government's policy, especially in England, was very direct. It was a kind of a brake on political policies, in the same sense as the House of Lords in years gone by may have been a brake. We have started out with a proposition that, after all, parliament is supreme, and we came to the conclusion that there should be more co-ordination between various sections of the government for the good of the country. Therefore, in the long run, or in any crisis, the government has to be supreme in seeing that whatever it considers its monetary policy is carried out. That has nothing to do with the day-to-day policies of the Bank of Canada. But, we felt that as parliament is supreme the Bank of Canada, therefore, would be in an invidious position if it should in its own wisdom feel it should prolong a delaying tactic over too long a period which would run fundamentally counter to the economic policies of the government.

THE CHAIRMAN: I see your point very well. You do not want to be specific about whether it is a power that should be held in reserve, or a power to be used only once in a while to indicate the line of policy?

MR. CREAN: I think if you are going to have co-ordination it cannot be a power that is held in reserve all the time.

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THE CHAIRMAN: There would be less reason for disagreement if it is a power held in reserve. That is the argument, in any event.

MR. KEEPING: If I may quote from page 7 of our brief, Mr. Chairman, we did say:

"This matter should be clarified, and the Executive Council recommends that the Bank of Canada Act be amended so as to give the government of the day the authority to issue broad directives to the Bank of Canada on overall monetary policy when the views of the government are contrary to the Bank's policies."

Does that answer your question?

COMMISSIONER GIBSON: You are really suggesting a sort of reserve power?

MR. EDMISON: Logically, in practice, if you have active consultation, that is what would be the case. That is, it is a power that exists, and it is very clear, and the ultimate responsibility is known, but if you have consultation going on all the time then it is very unlikely that that kind of directive ---

COMMISSIONER GIBSON: It has not been used in England, and yet the power is there. Those are all the questions I have, Mr. Chairman.

COMMISSIONER BROWN: Can I ask one question? Do you visualize this directive, if it is issued, as being a public matter subject to debate in parliament?

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MR. CREAN: I think if it was issued, and it was not carried out, there would not be much else for the Governor of the Bank of Canada to do but resign, and if he did resign he would be free to give his reasons for so doing.

COMMISSIONER BROWN: Let us assume that he does not resign. Let us assume that the Governor is against it, but he feels it is something that he must carry out. Should this then be a public matter?

MR. CREAN: In our recommendations we suggest there should be from time to time -- and rather more frequently than has been the case in the past -- some information given in the annual report, and given to the financial press which can then disseminate it rather more widely in the country. I would think that in a case like this after a certain time had passed that the reasons for the adoption of certain policies would be given.

COMMISSIONER BROWN: It should be made public, but not until after the event?

MR. CREAN: That is our thinking, but not necessarily each year. That could be much too long a period.

COMMISSIONER BROWN: How long a period do you visualize?

MR. CREAN: I think that rather depends on -- I think you would have to let this build up of itself. It may turn out to be a statement every three months. I do not think we say in our brief that there should be any particular time.

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MR. McNALLY: I think the Commissioner is talking about the statement.

MR. CREAN: Are you talking about at a time of crisis?

COMMISSIONER BROWN: No.

MR. CREAN: I am not familiar enough with monetary policy to answer this question authoritatively, but I do read, as a layman, the annual reports of the Bank of Canada with a great deal of interest, and I would still read them if some kind of a report was made every three months.

COMMISSIONER BROWN: There is still some slight distinction here because you spoke earlier about the fact that parliament has to be in control of monetary policy. If it is the government that is initiating this directive, then that is not always debatable in parliament.

MR. CREAN: But it can come up indirectly. If there is a statement made it can be debated in parliament.

COMMISSIONER BROWN: That is my point. How soon after the event do you wish this document to be made public so that parliament can debate it?

MR. CREAN: I am speaking personally now, if I may ----

COMMISSIONER BROWN: I do not know whether the Canadian Chamber of Commerce has discussed this point.

MR. CREAN: --- in saying that there are a great many things that can come up in monetary policy

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on which it would not be for the good of the country to have statements made immediately by the Governor of the Bank of Canada. I think most of us here realize that. I think this would be more in the way of an attempt to educate more Canadians in the problems of monetary and fiscal policy than are interested in it at the present time. I do not think anyone here -- and neither does the Chamber -- visualizes that these reports should come out within a week, or two weeks, or three weeks. I think the matter all depends upon the type of crisis involved.

MR. CASE: Mr. Chairman, may I say just this, that we seem to have gotten off the main issue here. I, too, am speaking personally and I have not had an opportunity of discussing this, but are we not involved in the area of a financial crisis where monetary policy has run afoul of what government policy is in the fiscal way? It is the question of a directive being then given by the government which directive would override the policy which has been laid down as monetary policy by the Bank of Canada.

Going further into Mr. Crean's suggestions, it would be a very wonderful thing if it were possible for the Bank of Canada to disseminate the type of information which would be useful to mere laymen such as ourselves and which would help us to understand exactly what is behind it all. But, again, we are in the realm of where I do not think we can ever hope to attain a full understanding of monetary policy. It is the question of crisis where this directive comes

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MR. CREAN: Yes. I do not think, in a case where the directive is given in a crisis, that you can immediately reveal that crisis. I think it might be very disastrous if you did.

MR. CASE: But any suggestion that it be done on the basis of one month, two months or three months could again dissociate the two functions.

MR. EDMISON: Of course, you could have conflict without having a crisis.

MR. CASE: Yes, you could, but let us make those words synonymous.

COMMISSIONER LEMAN: I am afraid I am more confused than I was before we started. Let us go back to your own statement on page 7:

> "...the Executive Council recommends
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directive, do you want the public to know what the contention is between the two? That is a clear question, is it not?

MR. KERLIN: Certainly it is a clear question, but it is a little difficult to give a clear answer to it. I do not think it is possible for the Chamber of Commerce as a body to express an opinion as to a definite time when such information should be released to the public generally. I think it must be the government that has to decide that. If we were to answer such a question we would be setting ourselves up as having great discernment.

As I recall the deliberations of the Committee at the time this was made up early last spring, there was a matter that was prominently in front of us at that time, and maybe our submission has been to some extent influenced by the condition that existed between the Bank of Canada and the government at that time. However, I really think it would be unfair to ask the Chamber to define what should be expected. Its feeling is that the public should be informed at some suitable time.

THE CHAIRMAN: I suppose that it implies also that the differences between the government and the Bank should be resolved, and that in order to accomplish that the government should clarify its position and inform the Bank of what the policy must be?

MR. KERLIN: Without any hesitation whatsoever.

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THE CHAIRMAN: Yes, and you are not in a

position to recommend any formula or any particular method of doing that? That is a matter of mechanics rather than principle.

MR. KERLIN: That is right.

COMMISSIONER BROWN: There is a point here, though, on which I would like to get some clarification, and it is this: In your opinion, do you think there should be something in the statute with respect to this? When the Act is amended, should the amendment mention the time interval beyond which the government must not go without making a matter public? You are not prepared to say what that time interval should be, but do you think it should be statutory, or do you think it should be left to the government of the day to make the decision?

MR. KERLIN: Subject to what our chairman has to say, I will say that certainly our discussion at that time did not contemplate that. Is not that correct, Mr. Crean?

MR. CREAN: Yes. I, for one, would hesitate to put a time limit on it. I think you would run into considerable difficulties if you did.

MR. STRATHY: I think that is the responsibility of the government. The government, after all, is paramount, and monetary policy must be complementary to government policy or fiscal policy, and in the final analysis the government has to lay down the law if there is conflict. But, I do not think we ever contemplated that that had to become a public issue within any specific time.

COMMISSIONER BROWN: Then, at no time does it become a public document.

MR. STRATHY: It might not; that is right.

MR. EDMISON: It is permissive.

MR. STRATHY: It would have to become a public document definitely if a row broke out; otherwise it might never get to the public's hearing.

COMMISSIONER LEMAN: One wonders what you think the Bank can do that a subdivision of the Finance Department cannot do. It is responsible to the Minister of Finance.

MR. STRATHY: But it is responsible for monetary policy and the practice of monetary policy, which is not a function of the Finance Department.

COMMISSIONER LEMAN: You say it is not, and I ask you why it is not?

MR. STRATHY: Because it is a science in the realm of that of a central bank.

COMMISSIONER LEMAN: What I am driving at is whether you are placing the bank practically in the same position as a subdivision of the Finance Department, responsible to the Minister of Finance?

MR. STRATHY: No, I do not think so.

MR. CREAN: I think one of the things that formed the background of this thinking was the concern that it might be possible at some future date that the government of the day might neglect to adopt certain policies which afterwards it could say was not its ultimate responsibility. I hope I am making myself clear. If this was changed the government would have

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COMMISSIONER LEMAN: I would like to go back to your recommendation number 4, gentlemen. You have already talked a little bit about this, but you did not get down to any concrete considerations relating to it. What is it specifically that you have in mind here? You say that there should be established an advisory body of financial people on whom the government might call for advice on the technical aspects and effects of the government's operation in the financial market. Do you have in mind a body appointed by the government?

MR. STRATHY: Yes.

MR. EDMISON: Yes.

MR. STRATHY: We have in mind a body appointed by the government made up of people who are in the day-to-day management of, and who run, the financial affairs of the country. Such people would be appointed, and they would come down to Ottawa on call.

COMMISSIONER LEMAN: On call?

MR. STRATHY: Yes, either regularly or on

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MR. STRATHY: Yes, either regularly or on

call.

COMMISSIONER LEMAN: How often?

MR. STRATHY: We did not define whether they should come to Ottawa regularly, or whether they should be called upon when required, particularly when new financing is to be undertaken. Those financial people might conceivably be people in insurance companies and other organizations which are the ultimate institutional buyers and who are the providers of the savings of the people, as it were.

COMMISSIONER GIBSON: This is a different proposal from that of the Investment Dealers' Association, I take it. They proposed some kind of an advisory council whose duties would be related more to the financing of new issues.

MR. STRATHY: The Investment Dealers' proposal is largely that of an advisory body composed of investment dealers, is it not?

COMMISSIONER GIBSON: That was my impression, but I just wanted to be sure.

MR. STRATHY: I would say that in the view of the Canadian Chamber of Commerce this body would be broader than that. We envisage a body composed of people in the financial community at large, and that is why I mentioned insurance companies and trust companies, et cetera. I do not include the banks because I think they are, perhaps, in a different area. In our discussion this financial group appeared to be made up of people in the financial area outside of the chartered banks.

call.

COMMISSIONER LEMAN: How often?

MR. STRATHY: We did not define whether they should come to Ottawa regularly, or whether they should be called upon when required, particularly when new financing is to be undertaken. Those financial people might conceivably be people in insurance companies and other organizations which are the ultimate institutional buyers and who are the providers of the savings of the people, as it were.

COMMISSIONER GIBSON: This is a different proposal from that of the Investment Dealers' Association, I take it. They proposed some kind of an advisory council whose duties would be related more to the financing of new issues.

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THE CHAIRMAN: Do you contemplate two separate advisory councils -- one as proposed by the Investment Dealers, and one as proposed by the Canadian Chamber of Commerce?

MR. STRATHY: I can put two hats on. Putting on the one hat I will say that in the discussions we had with a group of people who were not, in my opinion, all in the financial business, it appeared that this suggestion is wider than that of the Investment Dealers.

COMMISSIONER BRWON: Were the banks in this group you discussed this with?

MR. STRATHY: Yes, they were.

COMMISSIONER LEMAN: In other words, you are suggesting that it would be good if the government got into the habit of seeking information on the street, in a sense?

MR. CREAN: Yes.

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MR. CREAN:
Because, in a time of crisis -- or, shall we say that we had been through a crisis to a certain extent. It is working pretty well now, not perhaps on this particular group of financial people I am talking about, but there is a liaison going on now in the financial community and Ottawa. I would say that the financial community would tend to think when the situation got back to normal, if there is such a thing as normal -- quieter than it has been -- that these methods that are now being effected might die down again and we might get away from this liaison situation which is developing so well at the moment and therefore formalizing; then it has to be done.

COMMISSIONER LEMAN: I am just trying to visualize how this body would work; how it would be constituted and how the government would proceed to appoint people to it and fire them off it when it does not like the advice it is getting. What do you have in mind really?

MR. STRATHY: Well, I would think actually if it got down to reall workability it would be a committee; an official committee of financial people who would be in the top category of financing; the top executive officers of financial institutions, but from there on their deputies, or the more practical working people in those particular financial areas might work with their opposite numbers in the finance department of the Bank of Canada for the actual practical working out of it. That is what is happening now to a certain extent, shall we say since

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the spring crisis developed. The top people in the financial field, I am led to believe, are being asked to come down to Ottawa to discuss these problems. The Bank of Canada and financial department officials at different levels, and perhaps even those in Montreal or Toronto or where they have branches of the Bank of Canada, are also discussing these practical problems at their levels, so the formalizing of this thing, it would seem to me, would be at the top level, perhaps as far as the publicity which is going to come out. From the top level it works down to their deputy level. Really the point we are making is in the commercial area. We feel this should be formalized, and it should be a recognized development procedure for government liaison with business and particularly in this element we are talking about, the financial end of business. It is not formalized now.

COMMISSIONER LEMAN: Sometimes there can arise a little embarrassment when you have a formal arrangement like this and the advice that is given is not followed.

MR. STRATHY: Yes.

COMMISSIONER LEMAN: Then you go on with recommendations 5 and 6 which again have something to do with your feeling about the relations between the Bank of Canada and the Minister of Finance and the market. One of the problems that we must keep in mind all the time has regard to the difficulties of picking people for the type of need you have in

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mind. Would you look at this a little bit in the reverse? Would the industry be willing to train Bank of Canada personnel if the Bank sent them out to spend some time in the shops, so-called?

MR. STRATHY: Yes, I am quite sure they would.

COMMISSIONER LEMAN: Perhaps that might be the easier way of accomplishing what you have in mind, would it not?

MR. STRATHY: Yes. I think there is an area of difficulty here, and perhaps one of the areas you are pointing out is important. This type of man says to himself: "I am being selfish but I can get more from private enterprise than I can get from government service."

While we did not discuss this reverse suggestion of yours I am sure the Chamber would agree that is perhaps a very practical way of doing this.

COMMISSIONER LEMAN: We have been told that there has not been a tremendous rush of applications to the Bank of Canada and the Minister of Finance from experienced people in the industry.

MR. STRATHY: That is right.

COMMISSIONER LEMAN: There has not been a big rush of applications for jobs in those departments.

MR. STRATHY: Well, I would think the layman might well feel that a man brought up in Ottawa in the Bank of Canada finance department during all his business career might tend to be a bit ivory

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COMMISSIONER LEMAN: The famous dollar a year man?

MR. STRATHY: Right. It seems to me that possibly business has to accept this responsibility and in different degrees of crises they might be expected to do the same kind of thing -- in a different degree with much fewer people involved. Maybe that is being a little bit idealistic, but certainly we have gone through a crisis and the best brains are needed in times of crises. Now, the best brains may happen to be both in and out of Ottawa.

COMMISSIONER LEMAN: Getting them together is the problem?

MR. STRATHY: Getting them together is the problem. I have not solved how you do it though because there is a problem of money; pay.

COMMISSIONER LEMAN: Yes, because obviously these people you are referring to certainly are not junior people. They would have to be the top men?

MR. STRATHY: No, they would have to be

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COMMISSIONER LEMAN: On page 8 you make a statement under section 3(a) when you comment on monetary policy and at the end of the first paragraph you state your belief that monetary policy will have a powerful and pervasive effect which is absent from other stabilization techniques. Well, now, can you adduce a little evidence about the effectiveness of monetary policy, the classic type of monetary policy instrument?

MR. EDMISON: Mr. Commissioner, you were asking us whether we think that monetary policy is effective in all circumstances?

COMMISSIONER LEMAN: Well, you sound a note of great optimism here about the effectiveness of monetary policy. One of the strange things that has happened to this Commission is that a lot of people primarily concerned with monetary policy have kept telling us that the most effective thing from the counter-cyclical point of view is fiscal policy, and most of the people concerned with the fiscal end have told us that we will get it from the monetary policy end.

MR. EDMISON: Well, you have quoted from the first paragraph. The second paragraph qualifies it to some extent in the suggestion that there is sometimes a tendency to expect too much from monetary policy. Certainly monetary policy has a good deal in its favour. If it could be applied promptly and over a period of time it could be pervasive, if it is

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In the case of monetary policy we are at the moment at least in a non-inflationary environment. We have a lot of our resources, both plant and human, unutilized. We have a classic situation where monetary policy can be applied. Based on most recent evidence that appears to be taking place within the framework of the problems on our balance of payments that we went through earlier in the year. Certainly in the present context you might say even by default we are obliged to use monetary policy in an expansionist way if we want to take up some of the slack in the economy.

One could expand the argument a little further and suggest that commercial policy, while

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One could expand the argument a little further and suggest that commercial policy, while

certain useful steps are being taken, some of the major decisions on commercial policy are made by other people and not made by us at all.

COMMISSIONER LEMAN: Well, some of the students of monetary policy as an instrument who are very close to the subject -- people working at it all day long -- tell us that it is still pretty hard to measure exactly what a certain dose of monetary action will accomplish in the economy. That is why I was wondering what was the basis of your great optimism in its effectiveness.

MR. EDMISON: I would not say that this particular statement is terribly optimistic. It is true the word "powerful" is used.

COMMISSIONER LEMAN: And "pervasive".

MR. EDMISON: But the word "powerful" is the word I guess you are seizing upon here rather than what follows in the next paragraph. Actually, let us say, the multiplier effects of monetary policy are very hard to discern. You can expand the money supply and if people are willing to borrow money and take risks -- they are not always willing to do so, but if they are willing to do so, then obviously monetary policy can be effective in an expansionist situation. It is possible that a set of circumstances could exist where you could increase the money supply and nothing happens.

COMMISSIONER LEMAN: Well some of you, or a lot of you represent large industries in Canada, or large companies. Among the group of you, would you think that in general the companies you represent

were affected in their capital investment plans by a change in the rate of interest of say 2 per cent?

MR. STRATHY: Oh, yes.

COMMISSIONER LEMAN: On the up side?

MR. STRATHY: In my particular business I saw it actually happen. In other words, the financing plans were discarded. The cost of money was too much and it changed over-night. Would you not say that was monetary policy coming down pretty hard, pretty fast and vigorously?

COMMISSIONER LEMAN: Yes, that would be a measure of effectiveness.

MR. STRATHY: And the multiplier applied to that, which is perhaps intangible, I think would be there and would have a rippling effect.

COMMISSIONER LEMAN: Should I then gather from the same sentence, and perhaps I put too much significance in the earlier sense in which I used it -- should I then gather from it that you feel that up to now our monetary action in Canada has been a little too timid and not decisive enough?

MR. EDMISON: What period of time have you in mind?

COMMISSIONER LEMAN: Well, let us take the post-war.

MR. EDMISON: I would say in the last five years it has been. Since 1956 it certainly has been, in my opinion. I do not know whether my colleagues agree with me, but I think if you are talking about the very recent term, monetary policy very recently is

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COMMISSIONER LEMAN: When we consider the amount of determination with which it should be exercised, a little later on on page 9 you express what I interpret to mean a recommendation that it be used with determination, because you say it may be recognized generally that tight money is intended to hurt, and then you go on to say that great care should be taken to ensure that it does not cause unjustifiable hardships in particular sectors. There you are obviously referring to the unequal incidence of certain actions when they are taken. What are the sectors where unjustfiable hardships arise mainly?

MR. EDMISON: Well, I think it is generally accepted that monetary policy tends to be a little blunt. Some people would be a little stronger than that in language. In a tight or restricted money period it really means you are allocating resources and there is a tendency for parts of the economy -- very often it has been said that small business or out of the way places tend to, under these circumstances and by reasons of geography and so on, experience more

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COMMISSIONER LEMAN: It might be ideal that when you are trying to reduce activity, you reduce everybody's activity by one per cent or 2 per cent, but it can't work that way, can it?

MR. EDMISON: No.

COMMISSIONER LEMAN: The way to arrive at your 2 per cent -- if 2 per cent is what you want -- is by knocking out some things. I don't think you can obviate that.

MR. CREAN: There is getting to be a bit of an opinion that in times like this it is a good idea to knock out sections that are not as economic as others.

COMMISSIONER LEMAN: I was wondering if really I should infer from this that you would be in favour of selective control?

MR. EDMISON: I don't think so. I don't think we favour that kind of interference with the free market system.

COMMISSIONER LEMAN: There is a certain amount of selectivity involved in this which has to be ~~used~~ to ensure that it doesn't cause any hardship?

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COMMISSIONER BROWN: I am not clear on how this great care will be taken by the monetary authorities?

MR. EDMISON: I think the assumption in this particular sentence that the Commissioner referred to was that we are talking about a set of conditions where you, in fact, have a tight money policy and where resources in a country are strained, and it is thought desirable that a man be contained by monetary restrictions through the banking system, and it is that set of conditions that we have dealt with here and therefore it is within this framework of a clear cut monetary policy under these conditions that the implementation of that policy, which will obviously create some hardships and a lot of handicaps, obviously cannot be financed under these circumstances and by those means envisaged.

COMMISSIONER BROWN: It is the intermediary you are asking to take great care, not the monetary authorities?

MR. EDMISON: It is just the implementation of the policy; the administration of your monetary authorities.

MR. KEEPING: I think we have looked to the intermediaries to exercise care.

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MR. KEEPING: No, no.

COMMISSIONER BROWN: Could I ask one more question? You mentioned the Federal Reserve System and I would like to get your ideas as to what extent Canada can carry out and maintain an independent monetary policy, particularly with a fixed exchange rate?

MR. CREAN: I would think that surely monetary policy and fixed exchange rates are also all tied up with the flow of capital coming into the country and the level of your tariffs and quotas. It is all there in the package, surely, isn't it?

You can probably maintain a relatively independent monetary policy if you want to do certain other things which would tend to put your monetary policy into operating in a relatively close way. Surely all these items are inter-related.

COMMISSIONER BROWN: But Canada has a fairly open economy; I think we are all agreed on that?

MR. CREAN: At the moment, yes.

MR. EDMISON: I think the Commissioner's point was that if you have a fixed exchange rate which you must defend, and you are north of a country where you have a monetary policy operative that might be going possibly in the same direction but at a different pace, that you place some restriction on how far one can go at any given time, and if one decided to go in the opposite direction from the Federal Reserve on monetary policy under conditions of a fixed rate, I

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[illegible]

COMMISSIONER BROWN: Could I ask one more question? You mentioned the Federal Reserve System and I would like to get your ideas as to what extent Canada can carry out and maintain an independent monetary policy, particularly with a [illegible]

MR. CREAN: I would think that surely monetary policy and fixed exchange rates are also all tied up with the flow of capital coming into the country and the level of your tariffs and quotas. It is all there in the package, surely, isn't it?

You can probably maintain a relatively independent monetary policy if you want to do certain other things which would tend to put your monetary policy into operating in a relatively close way. Surely all these items are inter-related.

COMMISSIONER BROWN: But Canada has a fairly open economy; I think we are all agreed on that?

MR. CREAN: At the moment, yes.

MR. EDMISON: I think the Commissioner's point was that if you have a fixed exchange rate which you must defend, and you are north of a country where you have a monetary policy operative that might be going possibly in the same direction but at a different pace, that you place some restriction on how far one can go at any given time, and if one decided to go in the opposite direction from the Federal Reserve on monetary policy under conditions of a fixed rate, I

suppose under a flexible rate theoretically you don't need any reserves, but I suppose in practice you do. Theoretically you don't, but under a fixed rate you have to have reserves to defend your rate and therefore you have to watch perhaps more closely than otherwise the activities of the Federal Reserve System. I think this is an overall background factor in most cases of the massive amounts of capital that can and do move across that border.

COMMISSIONER LEMAN: If I might go on to your recommendations 8 and 9 there. I gather that most of what you had in mind in this area when you speak of more public information, more public education on these economic and financial considerations, that is basically more statistics, more information, that you feel should be promptly gotten out to the public so that they can interpret the figures themselves, or is it the interpretation of the monetary authorities that you want them to have, in other words, an open mouth policy; you want the monetary authority to interpret the figures for the public and say what it makes of the situation?

MR. CREAN: This is a problem which the Chamber has in its own field. We put certain statements out, we put certain briefs out -- I hope this is not going to be one of them -- but I, in my travels across the country in years gone by have often been tackled by smaller businessmen who will say, "Why do you want to put all that stuff out; nobody can understand it anyway." Now, this is said more jokingly

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than anything else, but it is the same thing here, because I think your point of interpretation is the key, because I don't think more statistics would be the answer because you are talking to the grass-roots, a good many of the grass-roots people haven't time to spend, nor would it be of particular benefit to them if they did spend a lot of time going over reams of statistics and therefore the problem so often comes down to two issues; monetary policy, what does he think monetary policy means to him? He will relate it to whether it will give him an extra few thousand dollars, or relate it to something to do with -- maybe quite incorrectly -- to do with this crisis we have had in the last two or three months, but he is always going to try to bring it back to his own personal little affairs and maybe by doing more of a job of interpretation or by putting the financial press maybe in a more readily assembled form and they can disseminate that information, that might be helpful.

COMMISSIONER LEMAN: But these are areas where there is always room for a lot of arguments, are they not?

MR. CREAN: Yes.

COMMISSIONER LEMAN: Would you concede that the monetary authority more or less is in a position of trying to make people do what at that moment they do not want to do?

MR. CREAN: I don't think you would be realistic and deny that!

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COMMISSIONER LEMAN: I am wondering if

partly what is missing in Canada is a more informed financial press?

MR. STRATHY: Yes.

MR. CREAN: I think so.

MR. STRATHY: If I can say a word, some years ago I was involved in bringing over a number of members of the British Financial Press and so the format was to get the local financial press to get together for an open discussion with the British Financial Press, and I am not taking sides with the British Financial Press, but it was a most interesting discussion and the British Financial Press said that they considered their role as interpretative and analytical and constructive in what they were doing, whereas they said in their view the Canadian Financial Press were just reporters, so that I think perhaps there is a certain amount of truth in that in Canada. It is just a reporting job that is done instead of an interpreting job. So that the Bank of Canada issues weekly and monthly financial statistics that are extremely valuable, they are magnificent in their spread of information and they go to the masses, but if we go back to these masses that were represented, they don't see them and they don't understand them, but the financial press is an intermediary and it goes a long way towards educating the people who are affected by monetary policy.

In our discussions I feel that is what we felt; in other words, public relations had to be improved, and I don't say that that means the Bank of

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COMMISSIONER LEMAN: Even in financial circles, many people who are fairly adept at the study of statistics and trying to analyse the state of the economy, very often there arises a lot of discussion as to what would be the best direction to take as of a certain moment, but it is not too cut and dried. I believe that the monetary authorities at times would feel a little bit embarrassed by the burden of coming up and saying exactly where they think we are headed for the next few months.

MR. STRATHY: It wouldn't be appropriate for them at the time.

MR. EDMISON: I think that the point in recommendation 7 which is discussed here is national and interpretative. Recommendation 8, which is about the bank rate, I think you have coupled that in your original remarks. Recommendation 8, I think, was considered more as something beamed at the financial community, and that the bank rate is a signalling device and that it would be indicating what the trend is, what the policy direction is, at a given time in clear and unmistakable terms. Recommendation 7 is something that we have put in an ad hoc policy; something which has developed over a period of time, an educational interpretative policy

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which probably should be engaged in in perhaps groups like the Canadian Chamber of Commerce as well as others, as well as financial people.

THE CHAIRMAN: We will adjourn now for five minutes.

--- Recess.

THE CHAIRMAN: We shall resume now.

COMMISSIONER LEMAN: I have just one more question in this area of your submission, gentlemen, and that is the one where you refer to the composition of a Board of the Bank of Canada. There again, I suppose, we can visualize some difficulties about endeavouring to get quite the kind of composition you seem to be proposing here. Could you get down to a little bit more definite example of what you mean? For instance, do you think you could have active commercial bankers on the Board?

MR. STRATHY: That is an awkward area with Mr. Commissioner Gibson here.

COMMISSIONER GIBSON: We want your opinion.

MR. STRATHY: If you take the Bank of England, in my knowledge of the setup of the governors there, they are active, commercial bankers. They may be termed merchant bankers and they may not be exactly the same as a merchant banker in Canada, but they are free enterprise individuals in their own businesses in the financial community. I am led to believe that they fulfill the function as governors of the Bank of England in a very satisfactory manner. That is the angle we are pointing up here in this brief, that that type of man, if there is a counter-part to him, should be a director of the Bank of Canada. I would suggest our feeling is that the present directors have been selected on a more geographic and perhaps somewhat political basis -- I am cautious there, but on a geographic basis with

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the result that probably the best technical people for that role are not provided.

COMMISSIONER LEMAN: If you could conciliate geography with competence you would still try to do it in that way?

MR. STRATHY: Yes, certainly.

MR. CREAN: That is the thread which runs through our whole system, any system we have in Canada, the difference of England being a relatively small area and Canada being not only a very large area but a federal system or confederation.

COMMISSIONER LEMAN: How about an active partner of a bond dealers' firm?

MR. CREAN: Well, if he was the best man, I would say yes. Someone might argue he is privy to expert knowledge, which might set up some type of problem, but if he is a top-calibre man and is the best man then he should be there. He knows how to act in his dual capacity, or he should.

THE CHAIRMAN: Who is going to decide whether or not he is the best man?

MR. EDMISON: That is the problem with all appointments, is it not?

THE CHAIRMAN: That is right; unless you had a set of examinations they had to pass.

COMMISSIONER LEMAN: At least you feel the government should try, and see what happens?

MR. STRATHY: Yes.

COMMISSIONER LEMAN: Those are all the questions I have on this section.

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MR. EDMISON: The Commissioner spoke of bankers. You have right now a former chairman and president of a chartered bank and, as a matter of fact, a former president of this organization, Mr. Ashforth, who is a director and is obviously a very experienced person who would fit into this.

COMMISSIONER BROWN: Mr. Chairman, I should like to move from monetary policy to fiscal policy. On page 10 of the brief you say that you would favour tax adjustments rather than changes in government spending, particularly government spending which cannot be reversed quickly and which does not add to useful social capital. Just why do you make this choice, and what sort of tax adjustments are you thinking of?

MR. EDMISON: Mr. Commissioner, I think the feeling of the Canadian Chamber of Commerce is that the more desirable way, perhaps not as a fixed rule but the more desirable fiscal approach is on the revenue side, as we pointed out, because it is more flexible. If you have a fiscal policy that you wish to use to reactivate an economy, and later on you feel that such policies are no longer required, tax changes can be reversed quickly, whereas certain other kinds of programmes, the expenditure type programmes, generally speaking, are very hard to reverse. Some of them have a tendency to go on for years, particularly those which relate per capita payment, and so on.

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difficult to reverse, for they take a period of time. So, generally speaking, the feeling is that if you desire to use that fiscal policy as an anti-cyclical measure with this kind of a tax-cut method of corporate tax and individual income tax -- and most previous briefs of the Chamber have been in this direction -- it is felt that as we are a developing country these rates are too high and at the earliest possible opportunity the rate structure should come down. Probably the present time is an inappropriate one to reduce them, but the time should come when it is possible to use fiscal measures in that way.

COMMISSIONER BROWN: Would you confine it to corporation and personal income tax fields?

MR. EDMISON: Our feeling is that from the point of view of incentives, those are the more desirable areas to work on, apart from anomalies in the tax system which could be cleared up. There are always those which could be cleared up from time to time, but in this context we feel that the individual income tax and the corporate tax structure are the areas where the operating fiscal policy on the revenue side could be most effective and expedient.

MR. KEEPING: Particularly in the corporate tax field. In my opinion the corporate tax almost forms the cost of goods sold, and a reduction of the corporate tax would result in a reduction of cost and therefore put us in a better position competitively

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both in our home market on imported products and in our foreign markets.

COMMISSIONER BROWN: Could we take this as an understanding, that the price of products would be reduced if corporate taxes were reduced?

MR. KEEPING: I think it is logical to assume that that would be the case. Businessmen are honestly trying to expand their trade and certainly a great factor which would help them to expand their trade at the moment would be to reduce their prices so that their products could be more competitive, particularly in foreign markets.

COMMISSIONER BROWN: You heard Dr. Eaton this morning. He was of the opinion similar to that which you have just expressed, that corporate tax is passed on in the cost of goods. I would gather you would agree with that thesis as a general statement?

MR. KEEPING: I do.

COMMISSIONER GIBSON: As a general statement, but are there exceptions to the degree that corporate income tax is passed on?

MR. KEEPING: No. I think it is difficult to measure the degree to which it is passed on. I believe it has become so built into the cost it is passed on to all intents and purposes.

MR. EDMISON: Probably there are areas where no cost can be passed on.

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MR. CREAN: I think the degree of passing it on is very much dependent on how competitive the industry is. In many industries there is a good percentage of the income tax passed on. They would be far and away the majority of the industries in this country.

COMMISSIONER BROWN: I gather you see no political problem in raising these taxes again when conditions are good in order to pay off the debt incurred when we ran deficits?

MR. CREAN: I never noticed any particular outcry against raising corporate taxes; I mean, from a political angle most people seem to say it is a good thing.

MR. KEEPING: I am sure there would be squawks from businesses, but I think businessmen would realize that in the long term we have to balance our budget and operate in a business-like way as a nation.

COMMISSIONER BROWN: You speak about fiscal incentives and fiscal restraints, and you give some examples of fiscal incentives. You mention the Swedish system of tax-free investment reserve. Those carry with them government permission to use them in specific areas when it is thought that the investment is needed. Now, is this interference with a free system?

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MR. CREAN: At least you have some hope that some day you can use them.

COMMISSIONER BROWN: But you do not feel this is repugnant to your concept of free enterprise?

MR. CREAN: Personally, no.

MR. KEEPING: No, I feel, Mr. Commissioner, that we have to raise a certain amount of revenue in the government to cover expenditures, the necessary expenditures anyway, and it is incumbent upon us and on our government to raise that money in as equitable a way as possible so that it will, among other things, to the greatest extent promote the economy and foster economic credit. This is, as you are well aware, a big problem which is up before another Royal Commission.

COMMISSIONER BROWN: Yes, this is a problem before another Royal Commission.

MR. EDMISON: We mention further on in our brief that this would be an incentive for corporate savings, at least more incentive than otherwise, if such reserves could be set aside for the future without a tax penalty.

COMMISSIONER BROWN: I should like to return for a moment to a point discussed at the beginning with Mr. Gibson, and that is the problem concerning gaps. One point which to my mind was not made quite clear is your definition of a gap. What is your definition of a gap?

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MR. STRATHY: We are talking about the difficulties that some companies have in being able to finance their enterprise, and they may have credit worthiness and be producing a product for which there is a proper market but they cannot obtain adequate finances. Then there is a gap which has not been filled.

Presumably the Industrial Development Bank is one of the instruments which is set up to fill such a gap, and these new private enterprise companies, as we mentioned earlier, have also been set up to provide the finances to fill these gaps.

COMMISSIONER BROWN: In other words, if somebody is deserving of financing but is unable to find it in the private sector ---

MR. STRATHY: May we refer to my particular business? There is a cost of financing involved, whether you like it or not. So, raising a small amount of capital for a small company that is credit-worthy, the cost is too high.

The amount of dollars related to the amount of funds raised is just too high, so it does not happen. So, taking a private company and turning it public through the medium of the business which I represent, it almost has to be a company of a certain size before it can achieve that area. Possibly smaller companies do get publicly financed, but probably this is carried out on a highly-speculative basis, and the cost again is too high and it does not achieve what is wanted.

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The companies have to give away controls.

THE CHAIRMAN: There are thousands of small businesses carrying on today and presumably making a profit. They must all have raised money somehow at one time or another.

MR. STRATHY: Probably privately through their friends or families, family funds. I should think there are thousands of them, of course.

COMMISSIONER BROWN: What I am trying to get at is whether, with respect to filling some gaps in the capital market, you are concerned with the cost of raising the capital or the risk involved ?

MR. STRATHY: First of all, if there is all that risk involved then perhaps the credit worthiness is not there and it should not be publicly financed except as a speculation. But I think in our discussion we are referring more to costs.

COMMISSIONER BROWN: That is what I wanted to know.

MR. STRATHY: The Industrial Development Bank presumably provides those finances at a lower cost and does fill some gaps, -- without going into a broad discussion of the I.D.B.

COMMISSIONER BROWN: Perhaps we could have a little discussion on the Industrial Development Bank. You say you do not want to review it but obviously you have some thoughts on it. We have had some criticism that the Industrial Development Bank has been too conservative and not taken enough risks. Is it properly filling the need?

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MR. STRATHY: Usually probably [illegible] their friends or families, family funds. I should think there are thousands of them, of course.

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MR. STRATHY: First of all, if there is all that risk involved then perhaps the credit worthiness is not there and it should not be publicly financed except as a speculation. But I think in our discussion we are referring more to costs.

COMMISSIONER BROWN: That is what I wanted to know.

MR. STRATHY: The Industrial Development Bank presumably provides those finances at a lower cost and does fill some gaps, -- without going into a broad discussion of the I.D.B.

COMMISSIONER BROWN: Perhaps we could have a little discussion on the Industrial Development Bank. You say you do not want to review it but obviously you have some thoughts on it. We have had some criticism that the Industrial Development Bank has been too conservative and not taken enough risks. Is it properly filling the need?

MR. KEEPING: I would say myself, Mr. Commissioner, that the Industrial Development Bank has fulfilled a most valuable function for a vast number of us. In my opinion there is very definitely a question as to whether at the present time, perhaps since the expansion and the amendments to the Industrial Development Act some eighteen months ago, it is not now getting into a field where it is supplying funds to organizations which could raise those funds in the private sector. They would pay more for them but they could perhaps afford to pay more for them. I feel strongly there is a gap which I think the Industrial Development Bank has filled in the past and has rendered a great service, but I do think there is a grave danger myself that with the degree of expansion going on and with the comparatively cheap money it is able to supply, without taking into account the risks involved, it is going to enter into and is perhaps to some extent now engaging in activities which could be catered to by the private sector, which in my opinion, is undesirable. I think what we want to emphasize in our submission here is that we feel thereis a place for an institution such as the Industrial Development Bank, but we do not feel its place is in that sector which can be filled by private enterprise.

COMMISSIONER BROWN: What is the cost differential that you feel has to exist in a decision being made by the I.D.B. as to whether this is properly

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COMMISSIONER BROWN: What is the cost differential that you feel has to exist in a decision being made by the I.D.B. as to whether this is properly

their field or whether it should be financed elsewhere at a higher cost?

MR. KEEPING: I am not too familiar with this but I believe the I.D.B., under its Act, is really incorporated only to negotiate loans in cases where financing is not available from other quarters, and I believe they do take some steps, to what extent I do not know, to satisfy themselves that the respective customer has made some efforts at least to obtain capital elsewhere.

COMMISSIONER BROWN: Have you any suggestions as to improvements that you would like made?

MR. KEEPING: Not specifically. We make the recommendation here that a review be made in an endeavour to ascertain to what extent government financial institutions are impinging upon the private sector of the economy, and where it is thought desirable that such a review be made. We think if it should appear that government financial institutions are competing in the private sector then the government should vacate those areas.

COMMISSIONER BROWN: Some of these have been developed by government institutions showing the way, so to speak, and then private interests have come along. Do you say that this is a good area for the government to investigate?

MR. KEEPING: I could not agree more.

COMMISSIONER BROWN: And would you have the government institutions back away as private enterprise comes into the picture? That is what I am trying to get at.

MR. KEEPING: Yes. I think certainly in certain new products and new developments I think there is a field for the I.D.B. It is, I think, important so far as our economy is concerned, because I think our success in world markets will depend upon the development by us of new products.

COMMISSIONER BROWN: If the government agencies are going to do this should they step into fields which

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COMMISSIONER BROWN: If the government agencies are going to do this should they step into fields which

the private sector is not prepared to venture into at the moment? There may be an element of risk which the private sector is not prepared to accept. Would you not also accept the thesis that in taking that risk on behalf of the private sector,subsidies, to that extent, are acceptable in the initial stages?

MR. KEEPING: I think you have got to have some degree of subsidy in the initial stages. As we make it clear here, we are adverse to any sort of subsidy of this nature on a permanent and continuing basis, but I think you cannot argue otherwise.

COMMISSIONER BROWN: You can argue against the subsidy, but I want to know whether this was solely an argument against the subsidy?

MR. KEEPING: If the private sector cannot supply the funds at a reasonable cost then I think it is desirable in some instances that the government should step in, and to that degree I think you could say it is subsdized.

COMMISSIONER LEMAN: Before you leave that area I might mention that I am wondering whether, without getting into actual quantitative measures, you can give us the broad features of a situation in which it would be appropriate to resort to deficits in order to help the economy along. I think you said a little earlier that it might not be appropriate now. What sort of a complex of factors would you say would make it appropriate to do this?

MR. EDMISON: I think you have to look at

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MR. EDMISON: I think you have to look at

the situation in your economy and the amount of unused resources you have, and particularly the amount of unemployment that would cramp such policies in the first instance.

COMMISSIONER LEMAN: We have got both of those now.

MR. EDMISON: That is right, but we also have a rather large deficit now. Some people would argue that the deficit could be larger. We have had, of course, somewhat larger deficits than that that was forecast yesterday for the current fiscal year. We have had these rather large deficits in the past, and they have had a stimulating effect on the economy during that current year. However, there comes a time when the size of the deficit creates problems in itself and, therefore, if you engage in tax reductions at a time like the present you are going to increase the size of that deficit. It is quite possible that some kind of tax reductions, or deferment of taxes such as in the case of more rapid depreciation write-offs, and allowances for expenditures on research and development, and that immediate loss of tax revenue, would be justified even though there is a fairly large deficit because of the productive results.

However, if you engage in any massive tax reductions with a deficit such as the present one you can bring upon yourself another set of problems which might be just as great as the ones you are trying to erase. Therefore, I think when

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However, if you engage in any massive tax reductions with a deficit such as the present one you can bring upon yourself another set of problems which might be just as great as the ones you are trying to erase. Therefore, I think when

you talk about co-ordination of policies, and the emphasis on certain policies, it would appear at the present time in the policy area that one should lean a little bit more on the monetary policy than on the fiscal policy. I say that in the light of the circumstances we now face.

COMMISSIONER LEMAN: It has been suggested to us at times by many people that neither monetary policy nor fiscal policy alone would ever do the job when there is a real job to be done; that you must use both together in order to get somewhere. I am just wondering if you can find some typical circumstance in which the weight of informed opinion would favour tax reductions for this purpose.

MR. EDMISON: As you fully recognize, you must look at all the circumstances at any given time. At the present time we are well along in this particular phase of recovery. 1962 so far has shown something in the order of a 6 per cent increase in the G.N.P. over that of last year in real terms. Thus far in this recovery there has not been anything that could be described as excessive. I mean you have not got any excessive capital outlays. You have not got a great build-up of inventories and using certain criteria, at least, you have not really any great excesses in consumer credit. Therefore, at the present time, and in the face of the facts that we have had, and have in prospect, a sizable government deficit, and deficits at certain other levels of goverments in the country, it would appear that the

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stage is set for monetary policy to be used as the main instrument. I do not mean to imply that fiscal policy cannot be employed, but I think that monetary policy is the area in which we could move at the present time because there does not seem to be much danger in its use.

We are in a non-inflationary environment. We have a tremendous excess capacity in the country, and we have not any excesses that need to be worked out by the kind of monetary policies that were appropriate a few years ago, notably in 1956. This is an entirely different climate and environment.

COMMISSIONER LEMAN: With the hope that you could knock two or three percentage points off the unemployment index?

MR. EDMISON: That is right.

MR. STRATHY: May I be excused, Mr. Chairman? I am afraid I could not obtain space on a later flight.

MR. CASE: I have to make the same excuse, sir.

THE CHAIRMAN: Yes.

COMMISSIONER BROWN: On page 12 you refer to the Annual Reports of government financial institutions; that they should give more information and so forth. Has the Chamber an opinion on the financial statements published by corporations? Do you regard them as adequate and frequent enough?

MR. KEEPING: I do not think, sir, that the Chamber has any particular statement of policy on

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MR. KEEPING: I do not think, sir, that the Chamber has any particular statement of policy on

that particular question.

COMMISSIONER BROWN: It has been suggested to us that there is quite a lot to be desired in many of the financial statements of corporations in Canada, and that perhaps improvement in this respect might be encouraged.

MR. KEEPING: Speaking personally, I think there has been a tremendous improvement in the financial reporting of companies, but I would agree that in some cases there is still something left to be desired. I think our Federal Companies Act is out-dated, but I cannot say the same thing about the Ontario Act, I am glad to say.

COMMISSIONER BROWN: I do not think that we permit apple polishing here, do we, Mr. Chairman?

MR. KEEPING: I say that, sir, because I have had the pleasure of appearing before your Chairman when he was on the Select Committee which was considering the revision of the Ontario statute in 1953, I believe it was.

COMMISSIONER BROWN: This follows your point on page 13 about improvements in the capital market generally. You deplore the abuses and the unethical methods in the sale of risky and highly speculative stocks. This naturally leads to the question of control over raising capital generally and to the question of your opinion as to what improvements you have to suggest in this field. For example, would you be in favour of an S.E.C. type of operation in Canada?

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MR. KEEPING: I apologize, sir, but I did not understand your question in the first place. Would you mind repeating it for me. I am slightly deaf.

COMMISSIONER BROWN: You are obviously unhappy about some of the operations that are indulged in by people raising new capital in Canada.

MR. KEEPING: Yes.

COMMISSIONER BROWN: I am asking what recommendations you have to make for improvements in this field.

MR. KEEPING: I do not think we would be in favour of a federal body such as the S.E.C. I think we are in favour of the regulation of public issues through the Provincial Securities Commission. There has been undoubtedly, over the past years, a tremendous improvement in the operations of those Commissions in a number of provinces, but we still feel there is room there for improvement in the operation of the Provincial Securities Commissions. One improvement would be a fuller and more fair disclosure to be made necessary in prospectuses than perhaps is the case at the present time, but we definitely would not advocate an organization such as the Securities and Exchange Commission at the federal level.

COMMISSIONER BROWN: Why not?

MR. KEEPING: Because we believe it to be a very unnecessary, bulky and expensive organization for the issuer of capital. Speaking as an accountant, it is a gold mine, and I think that lawyers can say the

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COMMISSIONER BROWN: Well, have you any general comments about the efficiency of the capital market as it exists?

MR. KEEPING: I hardly feel myself competent to answer that question.

MR. CREAN: T.C.A. has carried off one or two of our members, unfortunately.

COMMISSIONER BROWN: Perhaps I can go on. You recommend the removal of the 6 per cent ceiling on bank interest. Do you think that higher rates would act as a form of rationing so far as borrowers are concerned?

MR. KEEPING: If higher rates were to result I suppose they might. It depends to what extent they might be higher. Our basic thinking behind this was that there is a very high degree of competition in the financial world at the present time; that at the time when the ceiling was set, I think it is fair to say, financial institutions with capital available were not as widespread in all parts of the country as they are now.

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We feel that we would be perfectly safe in leaving the setting of interest rates in the public market place, letting the ordinary laws of supply and demand prevail.

COMMISSIONER BROWN: Do you think that small changes in the interest cost affects business decisions?

MR. KEEPING: Small changes?

COMMISSIONER BROWN: Yes.

MR. KEEPING: Well, it depends on what is small and what is large. I would go so far as to say that the changes in interest rates do affect business decisions, undoubtedly, but very minor rates do not necessarily affect them.

Of course, I think there is no doubt that a company that is proposing to refund or even to raise initial capital likes to choose its moment when it can obtain that money at the lowest cost, and it depends upon the emergency with which it desires the money. That is a determining factor in the decision, as much as the rate of interest.

COMMISSIONER BROWN: Well, I am thinking more particularly of the type of financing that a company would get from a bank which would be presumably for temporary and recurring operations, and whether changes in the rates are going to make much of a difference.

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much difference to the type of money that chartered banks would be lending, on demand notes for financing inventories or accounts receivable and things of that type. I would not think it would make too much difference to the business decisions.

COMMISSIONER BROWN: So changes in the interest rates would probably not operate to ration credit?

MR. KEEPING: I do not think so.

MR. CREAN: It might have some effect.

COMMISSIONER BROWN: Would it have a larger effect on small business in the 21 per cent tax bracket as against the larger type in the 50 per cent tax bracket?

MR. CREAN: It is very hard to say in advance. Surely that would be found out by the policies of each individual bank.

MR. KEEPING: It is obviously costing the small taxpayer in the lower bracket more of his own money, but I still doubt whether it would be a major factor in arriving at his decision.

MR. EDMISON: From the standpoint of the lender, Mr. Commissioner, if you had a more flexible bank rate interest structure, logically there would be more demands upon them if they were permitted to lend at somewhat higher rates of interest than they are now permitted. There seems to be the anomaly in the system that you have this fixed rate and you have, of course, a prime rate so close to the maximum. Presumably if there was a somewhat wider spread it would

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make for a little more normal lending operations on the part of the banking system. I think the result would be indeterminate. I do not think any one of us could say what it would be. Obviously it would create more, let us say we hope, employment creating loans because of these margin situations that would be developing under the circumstances, but it still does not rule out the competition that exists in the banking structure. There is a good deal of that. This would make the whole rate structure more flexible.

MR. CREAN: I am told, Mr. Commissioner, that the rates which some small businesses pay for financing makes 6 per cent look like peanuts.

COMMISSIONER BROWN: And these people would probably be able to borrow more cheaply at chartered banks?

MR. EDMISON: Appreciably more cheaply.

MR. CREAN: That does seem to be an anomaly because the small businesses certainly, in my little experience, do borrow from these financial institutions at a rate which is not even comparable to the bank rates.

COMMISSIONER BROWN: In connection with the chartered banks, you have a sentence at the bottom of page 14, that it is recommended that the chartered banks' freedom in deciding to whom they should make loans should not be compromised. What is behind this statement?

MR. CREAN: Well, we just want to leave -- what is behind that is, we do not want directives going

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MR. CREAN: Well, we just want to leave -- what is behind that is, we do not want directives going

to chartered banks telling them what class of loans they are to make. I believe that is what is behind it, as I recall.

MR. EDMISON: There was not any suggestion that there be any interference between the banks in their relationships with their customers.

COMMISSIONER BROWN: Well, has this got some historical connotation?

MR. CREAN: I would not say so, no. I think you have got to read it with the sentence that follows along on top of page 15.

COMMISSIONER BROWN: Well, the last sentence on top of page 15 almost contradicts the sentence at the bottom of page 14.

MR. CREAN: Well, one of the thoughts behind the second sentence there is that often an American subsidiary can draw funds from its parent company if the parent company sees fit to allow it. This means funds coming in from outside of Canada which a small business cannot obtain during a period of moderate stringency.

COMMISSIONER BROWN: You say in one place that there should be no interference with banks in their decisions, and in the other place you recommend that the government introduce measures that will place small businesses with good credit on equal footing with larger businesses. In one place you say you do not want any interference with banks and you immediately turn around and say --

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principles? I do not think they are quite the same principle at all.

COMMISSIONER BROWN: We will leave that. How about term loans by the banks?

MR. EDMISON: Well, term loans are presumably an alternate access to the capital market generally. Under certain circumstances they presumably have their place. You are thinking perhaps of from one to five years, or something like that which has to do with the term. In some instances it is appropriate to have relatively short term obligations of that kind. In other cases it is more desirable to have 10, 15 or 20 years, or even longer, obligations in the capital market. I do not think one would generalize. I would think term loans should have their place just as serial debentures have their place in a public offering. The procedure of banks making term loans to certain kinds of businesses at certain times is appropriate as well as the sales to underwriters of serial obligations, as well as long term obligations to the public. I think these are all media in the sale of securities, depending on the nature of the business and the times at which the offering is made.

COMMISSIONER BROWN: Well, what I was really getting at was whether this sentence at the bottom of page 14 was included to indicate that there should not be any directive made to banks.

MR. CREAN: No, I do not see why there should be.

COMMISSIONER BROWN: Have you any opinion

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MR. CREAN: No, I do not see why there should be.

[illegible]: Have you any opinion

about whether banks should be given authority to lend on mortgages other than on N.H.A. mortgages?

MR. KEEPING: No, we have not any opinion on that. We have not given it any consideration.

THE CHAIRMAN: Well, that concludes the discussion, gentlemen. We appreciate your participation in it as well as the presentation of your brief. You have been very helpful to us.

MR. KEEPING: Thank you very much, Mr. Commissioner.

THE CHAIRMAN: We are much obliged to you.

We shall now adjourn until 9.15 tomorrow morning. We shall hear the brief to be presented by the Canadian Labour Congress.

--- Adjournment.

Royal Commission on Banking and Finance

DR. A. K. EATON

THE CANADIAN CHAMBER OF COMMERCE

Hearings held at

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MEMORANDUM TO:

ROYAL COMMISSION ON BANKING AND FINANCE

ANALYTICAL COMMENT ON CANADIAN TAX STRUCTURE

BY: DR. A.K. EATON

October 23, 1962

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3. Forever in every country it is the fate of tax systems to be held in low esteem by their general public. This, of course, is quite natural. Taxes seem to take something more from people than their money. Along with their money, most people seem to lose much of their ability to talk rationally about their own taxes thereafter. Reason and judgment become more than a trifle distorted and the most extraordinary arguments and propositions are quite earnestly put forward by people who in other directions would be utterly ashamed of the obliqueness, transparency or

fallacy of the sort of case they blandly put forward about their taxes. With the weight of taxes as it is today, perhaps this is not surprising but it can be a bit disconcerting for him who, from these vehement views, has to separate the wheat from the chaff.

4. Periodically, complaints against tax systems become epidemic. We are, or have recently been, in the throes of one in Canada. For many months past, speakers and editors have been avidly taking in each other's washing on this subject. No very deep truths seem to have emerged from these outbursts. Mainly, they have represented nothing more original or subtle than a chronic bellyache over the high level of taxes. However, due to the conjuncture of the current chorus with an election campaign, we have in the making a Royal Commission to explore and make recommendations.

5. There is something a bit pathetic in the perennial outbursts of legislators and the public proclaiming that what this country needs is a complete review and overhaul of the tax system. Squirming under the hair shirt of high taxes, an earnest legislator is convinced that there _must_ be a better and easier way of going about raising money to pay for government than the one he and his constituents suffer under. If, however, our hopeful law maker should visit the legislatures of other democratic countries, he could hear his own yearnings being expressed with equal fervor abroad though perhaps in a different language. Should he look into the tax laws of these other countries, he would find to his chagrin that his fellow reformers

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abroad were complaining about tax systems essentially the same as the one paining him at home. This is discouraging.

6. We have income taxes on individuals, taxes on corporations, death duties, sales or purchase taxes - general or on specific items, or both - extra heavy taxes on liquor, beer and tobacco, customs duties and property taxes at the local level. That is our package in Canada and it is pretty standard for most other western countries. True, there will be differences in detail and in the extent to which these various kinds of taxes are used. Revenue from direct taxes, those on income, corporate profits and property passing on death will form a larger percentage of the total in some countries than in others where more emphasis is placed on indirect taxes - taxes on expenditure. But few countries use any good forms of tax that the rest have not heard about and adopted.

7. There are two good reasons for this striking uniformity in world tax structures. The first is that good tax sources are scarce. The second is that troubles in the use of any particular tax multiply rapidly both in number and intensity as rates move upward. A variety of taxes spread thinly is the opimum arrangement. Since the variety is limited, the pattern becomes uniform with differences mainly in the intensity of use of each source.

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regularity in other countries. Debates on income tax, no matter in what country, will never fail to produce acrimony over the farmer problem where income appears to be less a matter of fact than of opinion. Indignation invariably will be voiced over the deductions allowed to corporations and self-employed persons but not to employees. The inadequacy of personal exemptions is ridiculed the world over. Lack of a clear line in law between capital gains and ordinary income will scandalize the uninitiated. Some bright fellow is almost certain to point out that the law does not even contain a definition of what income is in the first place. This will be a true statement and may pass as utterly devastating criticism even though the law of no other country will have succeeded in doing much better. Lack of incentives in tax systems is forever deplored. In all legislatures, strong men are made to weep over the ruthless manner in which revenue officials harass the long-suffering public.

9. Review and overhaul of tax systems are occasionally necessary, usually not, however, with the idea of dropping certain tax sources from the structure. Rather they are necessary to give systematic reconsideration to some of the main features of each kind of tax and the internal relations between them. Law, modified by decades of hurried annual amendments, will frequently need re-statement. Certain provisions which have been found useful in a minor section of one kind of tax may deserve broader application as part of the general revenue code.

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10. It would not be surprising if at any particular moment the revenue systems of most countries would need overhauling in this sense of internal review and reorganization. This is the sort of job governments naturally tend to shy away from. Tax laws are very complicated, and in them, whole litters of sleeping dogs are lying around, often in the most unexpected places. Ministers instinctively cringe at the prospect of exposing to a critical Parliamentary Committee the host of problems in tax law to which, in truth, there is no really satisfactory answer. For this reluctance no one should blame them and it is not surprising that the time never seems quite ripe for major tax revisions.

11. Furthermore, for those administering tax law, every change is pure grief. Among four and a half million incomes tax payers, many are not easily moved into new ways of doing things. Tax administrators will invariably agree with the Minister that one should not rush into these things. Also, officials of the Department of Justice at the drop of a hat containing a suggestion for rewriting tax law will, with unusual promptness, deliver an opinion that whereas words and phrases in the existing statute have been construed and interpreted by Courts and whereas a revision of the statute would largely nullify this body of jurisprudence built up over the years which gives certainty to the law, now therefore it would be too bad at this stage to upset the applecart - and up to a point this makes a great deal of sense.

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12. The Canadian tax system less than any other one could name among Western countries needs, general revision and overhauling. In 1948, after thirty years of patchwork adjustments and amendments, and following the disruption of the War, the Income Tax Act was completely pulled apart and systematically put together again. The result was an income tax law that few other countries can match in up-to-dateness. Also during this period the sales and excuse tax structure was greatly simplified and standardized. The Report of the Carter Committee on sales tax contains many useful recommendations in this field. The utterly complicated and illogical Dominion Succession Duty Act was then worked on and a major operation was performed in 1958, the result of which is a good, simple statute taxing estates of deceased persons. The rate structure is probably too severe for a "young" country but the law is modern and the best there is. There are a few directions in which the system needs change. The Government and their officials are quite aware of them.

13. It is well established that few other national tax systems can compare with ours in simplicity of concept, adherence to principle and flexibility. At a recent international Tax Conference, it was stated in effect by a representative from abroad, that no country had been more prolific in supplying unique ideas for the solution of difficult tax problems than Canada. Canadian methods of dealing with certain awkward tax problems have been widely copied in other countries. In negotiating tax Conventions with other countries for

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So much for background and perspective.

Does Income Tax Discourage Economic Activity, Saving and Investment?

14. It is not within the proper scope of this memorandum to undertake a general assessment of our tax structure as a whole,to argue whether on balance it is a good one or a bad one, whether it is fair or unfair. However, it is appropriate to the field of enquiry of the Commission to offer comment on whether our taxes have harmful effects on economic activity, on enterprise generally, on saving and capital formation in particular. Do taxes impair the capital marketing process as a mechanism in our society?

15. It is the fashion generally to assert that personal income tax discourages work, enterprise, ambition, saving and investment. Quite uncritically, this proposition finds pretty widespread acceptance. Possibly, there is some truth in it but it almost goes without saying that the bad effects of taxes will be greatly exaggerated.

16. During the last war when income taxes were pushed so high so quickly, the Minister of Finance received quite a volume of letters from employers complaining about the difficulty of getting men to work overtime, weekends or even for a full week. Absenteeism

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was quite bad in spots. Employers blamed the high tax, deducted at the source (for the first time) - a higher rate was withheld as earnings per pay-period increased. Undoubtedly, the tax plus forced savings caused considerable resentment - many never believed they would get back their forced savings - and slacked off in effort as a result. But it should be remembered that coupled with the high tax were unusually high levels of earnings beyond what many were accustomed to. Good jobs were a certainty and it is not too surprising that tax resentment plus ample security led to some indifference to unusual effort.

17. In recent years when jobs are relatively scarcer and more highly prized, one never hears of refusal or reluctance to work in the lower or middle income groups. The tax is now fairly low in these brackets and deduction at the source is taken as a matter of course without comment. After all, with an average industrial wage of only about $75 a week the tax taken from a married man with two children is only $3.65 a week. However, with a pay increase up to $100 a week, his tax would increase to $8.25 a week, leaving him only $20.75 better off out of a $25 pay increase. This is the sort of result from a steeply graduated tax that can cause some concern among high bracket wage and salary workers. Probably, however, for ordinary routine work a man will try about as hard for promotion and pay increase as he would in the absence of income tax. It is likely that the tax angle will be looked at more closely, however, by a person who has a chance

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to make a break and move to a higher paid job elsewhere. He may decide that the after-tax benefit does not quite justify the risk and trouble of moving his household. This, of course, is not good and there must be quite a number of cases of it.

18. About $5\frac{1}{2}$ million people in Canada file income tax returns. Of these about 5 million never encounter a marginal rate of tax (tax on increases in earnings) of 25%. Perhaps then it can be said that this group (plus those who do not even file returns), making up over 90% of the workers in Canada, do little if any less work because of income tax. Probably in few cases will ambition to improve their lot and accordingly the lot of the community be dimmed by income tax.

19. If the above generalization is somewhere near correct, then it might be held that income tax is not quite so bad as it is made out to be. However, there are about half a million tax payers whose marginal rate of tax is above 25% and above this point the rates increase quite steeply quite soon. The rate is 35% on taxable income above $10,000, 40% above $12,000, 45% above $15,000, 50% above $25,000 and 55% above $40,000 and so on. It is within these income ranges, the top 10%, that the potential bad effects of income tax will be expected.

20. It is a great temptation to simply assert in strong terms that of course our high tax rates are stultifying, that they take way inclination to work hard for promotion and extra gain, undermining ambition to get ahead and willingness to risk going out on a limb

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for success and generally that they kill the urge to follow the natural instincts of an enterprising spirit. Certainly they cause widespread resentment. But those who have seriously attempted to verify and give substance to these easy generalizations have not been too successful.

21. Some years ago, Professor G.F. Break (U.S.) made a study in the U.K. of income tax and incentive and published it in the American Economic Review, September 1957. The results were by no means conclusive even for the U.K., where income tax is much more severe than here. Professor Break apparently found about as many cases where more time, zeal and energy were devoted to maintaining position and status (e.g. good public schools for the children) because of the inroads of income tax as there were instances of defeatism and the inclination to say what the hell's the use and take it easy. One cannot, of course, be sure that the less conventional and presumably less supine? Canadian temperament would show the same results but it is a good guess that it would. The sheep-like acquiescence in government authority and all its works in Canada is pretty appalling. Too soon, too easily we adjust to even bad law.

22. Professor Break confined his study to professional men as relatively the most independent group free to react to income tax effects. Probably his conclusions would not be altered much after testing the top brass in business concerns.

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many which over the past years have poured in over the tax policy desk in the Department of Finance, has been on behalf of young business executives. The claim was that because of income tax they constantly tend to play it safe, that they seem to lose the spirit that may make or break them, knowing presumably that if it makes them, the rewards will be sadly depleted by obligations to the Receiver-General. So, it is held, they play it cozy, which is an abomination unto progress.

24. One might be more impressed with the claims in the preceding paragraph were it not so obviously the prevailing fashion among bright young businessmen to worship status and all its symbols. As things are, it is not too easy to visualize among them any widespread indifference to work, promotion, rank and title because of the unconscionable swipe at the pay envelope taken by the government.

25. All in all, not a very good case can be made for claiming that the gross national product in Canada today is much less than it would be in the absence of the effects of personal income tax on the economic activity of individuals.

26. Does personal income tax affect the willingness of people to save capital for investment? That is, does the tax on income in the form of interest, dividends, rents and royalties discourage the process of savings? Economic theory gives some help in answering this question. While the supply of savings that may be attracted to any particular use may be highly elastic in response to yield, the <u>total</u> supply

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of funds saved out of income within a community is not very responsive to the return on it. If this is so, it follows that a tax which reduces the effective yield will not greatly affect the willingness of the public to save.

27. A very large part of income from investment of savings in Canada is not subject to income tax in any case. For example -

(a) Income from an investment in a house occupied by the owner bears no tax in Canada. For the sake of equal treatment between taxpayers, it should be. Imputed rent is taxed to the owner-occupier in U.K. and Australia for example, but not in Canada.

(b) Earnings on all insurance-endowment policies, credited to or received by policyholders at maturity, never bear income tax. Furthermore, the insurance company itself is not taxed on its investment income, but only on the amount transferred to shareholder account, if indeed, it has shareholders. Mutuals pay no income tax at all. The accumulated earnings on a single premium 40-year endowment policy come to the policyholder for spending, untouched by income tax. Interest accumulations on annuity policies likewise bear no tax up to the time of the commencement of the annuity.

(c) Interest and dividend accumulations in all government, industrial and private pension plans and registered retirement savings

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(b) Earnings on all insurance-endowment policies, credited to or received by policyholders at maturity, never bear income tax. Furthermore, the insurance company itself is not taxed on its investment income, but only on the amount transferred to shareholder account, if indeed, it has shareholders. Mutuals pay no income tax at all. The accumulated earnings on a single premium 40-year endowment policy come to the policyholder for spending, untouched by income tax. Interest accumulations on annuity policies likewise bear no tax up to the time of the commencement of the annuity.

(c) Interest and dividend accumulations in all government, industrial and private pension plans and registered retirement savings

plans, escape tax up to the date of maturity of the pension and even when received in pension, form little or no tax is payable in a large proportion of cases because of personal exemptions.

(d) Much of the coupon interest on ordinary government bonds escapes income tax simply because it is not reported.

28. All in all, there is a pretty lusty annual crop of investment income in Canada that completely escapes the income tax net. In this sense, there is a quite substantial tax incentive for the accumulation of capital here for investment.

29. As against the above favourable factors, the volume of capital accumulation in Canada is very adversely affected by the pattern of our tax structure and through the use if taxation in financing the paraphernalia of the welfare state. The redistribution of income in the community from those who otherwise might be expected to save and invest, down to those who might not be expected to save and invest, is adding up these days to a pretty impressive volume of money. It is scarcely any wonder that Canadians are making no progress toward repurchasing ownership of Canadian industry from foreigners and that they will have to sell their bonds abroad in considerable volume annually to secure funds for capital investment in Canada.

30. Our personal income tax structure is graduated from 11% to 80%. If the graduation were abolished, the same volume of revenue could be obtained from a

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30. Our personal income tax structure is graduated from 11% to 80%. If the graduation were abolished the same volume of revenue could be obtained from a

flat rate of tax of 16% on all taxable income. This fact reveals very clearly the futility of trying to help very much the general standard of living of labour groups by putting steeply graduated taxes on the medium and upper incomes. Canada is not a rich country in the sense of having a large number of well-to-do people with substantial investments. This fact has long been evident in the pitifully meagre returns from a special tax on investment income in Canada. Two decades of steeply graduated taxes have made capital accumulation by individuals very difficult. Our medium and upper income tax brackets are in fact very thinly populated.

31. Because uf this situation, the annual loss of revenue to the Treasury through putting a ceiling of 50% on personal income tax rates - i.e., chopping off the 55%, 60%, 65%, 70%, 75% and 80% rates - would be less than $10 million. This sounds a bit unbelievable, but there it is. A rate ceiling of 40% applying to all taxable income in excess of $12,000 would cost in revenue loss only about $40 million. It is quite obvious that the income tax structure is a product of popular politics rather than of economic or even revenue considerations.

32. Social welfare is the largest item of government expenditure in Canada today. For all three levels of government, the amount currently spent adds up to about $3 billion a year. This huge sum is by no means solely directed to the poor who need it but is poured out over everybody generally without a means test. Old age pensions, family allowances and hospital benefits

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go to nearly everybody regardless of income status. In a few provinces, the premium or contributory system is casually nodded to in financing welfare, but over-all, federal, provincial and municipal funds are mainly raised by taxes, which through wide income ranges are roughly proportional to income, or in the case of income taxes are away more than proportional to income in all ranges. It follows from this system of financing that always the majority - and not just the poor who need it - get something for nothing.

33. Generally speaking then, under our Canadian system of financing welfare expenditure, there is no relation between what a person contributes towards his social security and what he receives. Benefits are the same for all, but a person with twice the income of another will pay about twice the premium for his insurance by the State. With then times the income, his premium will be about ten times as much. Under our income tax schedule, a man with $2,000 taxable income pays $250 tax, with <u>five</u> times as much income he pays <u>eight</u> times as much tax. With <u>twenty</u> times as much income he pays <u>sixty-four</u> times as much tax. Federal income tax is the largest single item in financing universal flat rate welfare benefits. With welfare expenditure of about $3 billion, the redistribution of income through the taxing process in Canada runs into pretty impressive totals.

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above a certain level of income should contribute towards the aid of all unfortunates in the community who are in need, to those who from one cause or another find themselves below what might be called the poverty line, in need of financial help either temporarily or permanently - the Jesus(?)-type of redistribution. No one should quarrel with this principle, and with a poverty line very generously drawn. In practice however, it works out that there is a general redistribution of income downward throughout the whole range of incomes so that, for example, the taxes of the $10, $20, $50 or $100 thousand a year man are less than they otherwise would be because everybody above them pays more for the support of Government than they do.

35. This latter form of indirect general redistribution of income downward has, of course, been going on whenever and wherever graduated or proportional taxes have been in effect. It appears, however, that in Canada at least, there has never been an overt declared policy of redistributing incomes. It has merely been that taxes have been levied in such a way that redistribution has been the end result. Policy discussions, if any, have been confined to the manner of spreading the tax burden. This was all very natural and sensible when the greater part of government expenditure was for general services of an intangible nature, such as for defence, maintenance of order, courts, legislative and administrative activities of all kinds, providing the general framework for organized community life. Here there is no measure of the extent to which any citizen

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benefits directly from these government services and it has been generally accepted that under the circumstances taxes should be levied according to "ability to pay".

36. Canada seems to have moved quite easily and comfortably into the concept of the Welfare State. And it seems that almost without policy debate in Parliament on the principles to be followed in paying for it, we have drifted into the politically expedient method of pooling the cost. In effect the politicians have suggested we all get together and in family fashion look after each other's old people, the having of babies, hospitalization for chicken pox, broken arms and legs, bad appendixes and so on - the host of normal expenses that in all income brackets we all expect to have to meet sooner or later as we move along with daily living.

37. We have not in Canada adhered to the insurance principle as some other countries have, nor have we followed the contributory system with the State merely setting up the machinery under which most would be induced through premiums to make provision for themselves. We have not insisted generally on means tests with the State filling in where the individual is unable to provide. One hears quite frequently in Canada the view that means tests are embarrassing, undignified and old-fashioned, that state benefits - transfer payments - should be a matter of right.

38. The purpose of the foregoing is not to indulge in a futile diatribe against the majority in our democracy who directly benefit by this system and give it their electoral support - and who can blame them?

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Rather it is to call attention to a by-product of this situation where across the board huge sums are taken from those who otherwise could accumulate capital for investment and are passed down for spending by those who cannot be expected to save capital for investment.

39. It is frequently stated these days that as a nation we are living beyond our means. Of course the majority of our people are actually living beyond their own means, through transfer payments of cash and services which belonged to other people, effected by the tax system. Accordingly, individual saving by the majority for capital investment which the nation needs is under a pretty severe handicap and it gets worse every year.

40. Whether because of the relative scarcity of investment, capital forthcoming from individuals because of the inroads of taxes or for other reasons, the fact is a very large proportion of the capital for industrial and commercial expansion in Canada is supplied upstairs by corporations themselves from undistributed profits. In this manner, profits of the industrial system never have to pass through the personal income tax net (although, of course, the corporate tax applies). Furthermore, with no tax on capital gains, the equity value added through ploughing back earnings can be realized by the shareholder tax free through subsequently selling out. This development, to some extent, has circumvented the general adverse effects of the tax system on capital accumulation.

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businesses, it might be argued, tends merely to perpetuate existing firms making them into larger and larger units and does not in any way help to bring along new enterprises in the same or entirely different kinds of business. This generally is true but there are, however, encouraging signs that new financial institutions may develop which will specialize in this very field of financing new small industries. Again, there is scope here for the use of upstairs venture capital in short-circuiting the personal income tax obstacle.

42. To this point, the income tax on <u>individuals</u> has been looked at in an attempt to assess broadly its effects on economic activity in the community, on the willingness and more particularly the <u>ability</u> of people to save and invest. We now come to the tax on corporate profits, that amazing phenomenon in the capitalistic system that has become so solidly entrenched in government revenue systems over the past two decades. It is as near the truth as makes no difference to say that over the past two decades, taxes on corporate incomes have on this continent (Canada and the U.S.), taken away about half the profits of the capitalist industrial system. If not long ago one had asked an economist what would happen if taxes took away half the rewards of capital investment under our system, he would blandly and with certainty have answered that there would soon be no private enterprise system left, that new investment would wither away and that the system would rapidly grind to a halt. And how wrong he would have been. The fact is, of course, that under these

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conditions we have witnessed the greatest investment boom that this country has ever experienced. This takes some explaining.

43. Of course it is known that the post-war period was one of pent-up demand, with scarcities over wide ranges and that this naturally brought on new investment on a huge scale. But even so, one is entitled to some doubt that this boom would have gone on so merrily had not investors seen the opportunity of good profits <u>at accustomed</u> levels <u>after tax</u> from their new plant and equipment. From this, it does seem to be a fair assumption that the main burden of the 50% corporate tax was being passed on in higher prices.

44. Generally in the post-war period it was a sellers' market. It was the ordinary thing for business generally to operate with a heavy volume of unfilled orders. Under these conditions it would not be too difficult to edge prices up slightly, to recoup the tax on profits. And prices would only have to be moved up <u>slightly</u> to accomplish this. Over industry as a whole the profit take averages only about 5% on gross sales. Thus, just a few percentage points of gradual upward adjustment in prices would replace in profit and loss account the additional amount taken out by the government. It would work out this way quite easily if all firms in an industry followed their inclinations in this direction - and they probably would.

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is worthwhile to look at the after-tax margin. Corporate tax is treated in exactly the same manner as federal sales tax - just another cost to be recovered in prices. Almost universally, businessmen admit that they recoup themselves the corporate tax out of prices. "How else do you think we stay in business", they say.

46. The lack of any clear generally accepted theory of the incidence of the corporate tax these days completely bedevils all discussion of the effects of the tax on business activity and new capital investment. And the disconcerting fact is that scarcely anyone who professes a theory will accept the logical implications of it. It is a mess!

47. Businessmen who admit they recoup the tax in higher prices will mourn on public platforms over the weight of the tax burden on them - and they are not grieving over a slightly lessened sales volume because their prices are a few percentage points higher than they otherwise would have to be. Some years ago, a dividend tax credit was given by the Government to partially remove so-called double taxation on the shareholder. From the same forum, it was subsequently asserted that the tax is passed on to consumers in higher prices, that it is in effect just another sales tax and that the CCF party were just fooling themselves in advocating higher corporate taxes.

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50. If classical theory is right, then business profits available for dividends in Canada are annually about $1½ billion less than they would be in the absence of a tax on corporate profits. Prices are no higher because of the tax so the volume of sales is unaffected by it. It would likewise seem to follow under this theory that the incentive to invest is very substantially impaired by the corporate tax and, therefore, it must be a severe penalty on business growth and development.

51. If businessmen are right in claiming that the corporate tax is treated as a cost and generally included in price, then the volume of profits available for dividends to shareholders is unimpaired by the tax, prices are just a little bit higher but the incentive to invest and the funds available for investment are scarcely touched at all by the tax.

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views on the incidence of the corporate tax, one is supposed here in this memorandu, to say what its effects are on economic growth and the capital market in Canada. The conclusion in this memorandum is that the businessman's view is much nearer the truth than the deductive case put forward in classical theory. If the text-book theory were mainly right, it seems to prove too much. With pre-war tax of 10%-13%, it is a bit hard to see businessmen accommodating themselves so easily to the remnant left after 50% is taken away. Businessmen seem to have a pretty strong conventional sense of what is worth going after and they will quite readily decide not to attempt a line that cannot be sold at a price to give a reasonable profit after all costs including corporate tax are recovered. It certainly does not seem that there has been much holding back in Canada over the past two decades. There has in fact been a pretty wholesome spirit of enterprise with good profit margins generally in most directions. This is hard to reconcile with a strict belief that the incidence of the corporate tax over this period has been on the owner of business enterprises. The actual facts of what has happened seem far more acceptable if one assumes that pretty generally as a matter of ordinary business procedure in pricing policy, that the tax is passed on in slightly higher prices.

53. In recent years we have seen in Europe a very substantial business expansion, with new investment passing all previous records. This has taken place under systems of corporate tax burdens in European countries

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not much less than those prevailing on this continent.

54. Of course, in regulated industries such as the railways and telephone companies, the corporate tax is quite openly passed on to consumers. In arguing for rate increases, Bell Telephone for example, argues that in order to attract new capital they have to maintain certain dividend rates. In order to pay an additional $1 in dividends, they have to have an increase of $2 in their profits. They then argue for rate increases which will give this $2 profit so that after tax $1 will be left for dividends. The Board of Transport Commissioners agree with this argument and grant the rate increases, which, of course, includes the piece to cover corporate tax. Ordinary uncontrolled business does not have this arbitrary price fixing but it is a fair assumption that businessmen pretty much automatically reason in the same manner as the regulated companies and universally act accordingly.

55. It is perhaps not very good evidence, but it might be worth recording that in war-time with an excess profits tax in force it was very common for businessmen to state that they would much prefer a straight flat rate tax up to 60% or more on total profits, rather than a 40% minimum, with 80% of 100% on the excess, with 20% refundable. With a flat rate tax, pricing was simple and they knew where they were. Also it might be noted that after the war, there was little, if any, real pressure back of protests against the corporate tax which took away about half of business profits. The business world accepted this scale of

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taxation without any very vigorous protest. Surely they would not have done so had it meant that profits were reduced from what they were used to by the amount of the tax. It does seem as if business were taking care of itself quite adequately and did not have the nerve to squawk as they might have otherwise been expected to do.

56. Personal income taxes were successively slashed after the war. Most special excise taxes were either abolished or reduced. The federal sales tax was not lowered after the war, but then it was never increased during war time, and it stands at the same level today as it did in the thirties (old age security tax of 3% has been added to it). But the tax on corporate profits has never receded from its war time peak either here or in the U.S. True, it is politically an easy tax to put on and a hard one to take off, but even so, if it were as harmful as text-book theory makes it out to be, it is doubtful if it could have survided at present levels for so long nor, it is suggested, could the capitalist system on this continent have flourished as it has during the period of high taxation.

57. So, biting the hand that feeds him these days, the writer of this memorandum concludes as a general proposition that corporate tax is mainly passed on to consumers, that industrial and commercial profits in Canada are not appreciably less than they would be with no tax on corporate profits, that prices are slightly but not much higher, that the incentive to invest and the capital available for investment have not been

they would not have done so bad it meant that profits were reduced from what they were used to by the amount of the tax. It does seem as if business were taking care of itself quite adequately and did not have the nerve to squawk as they might have otherwise been expected to do.

56. Personal income taxes were successively slashed after the war. Most special excise taxes were either abolished or reduced. The federal sales tax was not lowered after the war, but then it was never increased during war time, and it stands at the same level today as it did in the thirties (old age security tax of 2% has been added to it). But the tax on corporate profits has never receded from its war time peak either here or in the U.S. True, it is politically an easy tax to put on and a hard one to take off, but even so, if it were as harmful as text-book theory makes it out to be, it is doubtful if it could have survived at present levels for so long nor, it is suggested, would the capitalist system on this continent have flourished as it has during the period of high taxation.

57. So, hitting the hand that feeds him these days, the writer of this memorandum concludes as a general proposition that corporate tax is mainly passed on to consumers, that industrial and commercial profits in Canada are not appreciably less than they would be with no tax on corporate profits, that prices are slightly

appreciably impaired because of it, briefly, that gross national product in Canada is about what it would be if the same volume of corporate tax revenue had been collected in some other way, say, by means of sales taxes on commodities and services generally.

58. Recently the Canadian Tax Foundation has published a Tax Paper under the title "The Burden of Canadian Taxation". It was written by Professor Irving Jay Goffman, a Montrealer now at the University of Florida. It is an excellent piece of work, the type of study long needed in Canada.

59. One very creditable thing about Professor Goffman is that he is not satisfied, as so many writers on this subject have been, with fuzzy indefinite statements. There is no pussyfooting in his conclusions about the incidence of the corporate tax. He says precisely what he thinks. Here is what he ends up with:

> ".....it seems reasonable to divide up and distribute the total burden of the corporate profit's tax in the following manner: 55% was borne by profits, 30% was passed on to consumers through higher prices, and 15% was shifted to workers in the form of lower wages. But these, of course, are only judgments of the writer, based on qualitative rather than quantitative analyses".

60. Without attempting any further argument, the <u>opinion</u> is expressed here that Professor Goffman's views are quite out of line and that about 90% is passed on to consumers, 10% on shareholders and none on wage earners.

61. In the preceding paragraph it is stated as a general proposition that the corporate tax is mainly passed on to consumers. This, of course, may not be completely accomplished in all industries at any point of time nor completely true for any particular industry throughout the cycle of recession and recovery. But even if in some instance the tax remained on the corporation, it cannot automatically be assumed that this would mean much by way of discouragement to new investment.

62. Decisions regarding new investment are made upstairs by the management and submitted to directors of the corporations for approval. It is true that the directors are the trustees of the interests of the shareholders. In practice, of course, they tend to see the interests of the shareholders being pretty adequately looked after if they can make the business grow. In the cult of modern business, it is practically an article of faith that the only alternative to growth and expansion is a lingering death. In this view there can be no standing still. To halt is to perish. Growth is the price of survival. New inventions bring obsolescence in their train practically compelling new capital outlays. Values of existing assets can be maintained only by modernization involving new capital expenditure. Pressures within a dynamic economy constantly override the cautious calculations of the financially-minded who tend to be preoccupied with close percentage yields. Most of the urgent drive for the bigger, better and faster ignores the unpleasant fact of having to share

with the government the fruits of success in broader fields of activity. New records of greatness pass as proof of the soundness of progressive management.

63. In Canada - in the past at least - capital expenditure in finding and developing new sources of minerals and energy has tended to set the pace for country-wide business expansion. Here the main driving force is not immediate profits carefully calculated as a percentage on new investment. More likely it is the fear of future scarcities and the urge to acquire inventory in the ground to give security for the maintenance of future operations. Natural resource development in Canada has largely become empire building. The immediate level of profits and taxes thereon is not too significant.

64. Within this milieu of compulsions and urgencies in both primary and secondary industry, are obvious grounds for caution in accepting too readily easy generalizations about the effect of high corporate taxes on venturesome capital. The diverse mixture of motives and circumstances governing investment decisions in a growing country defeat the search for simple conclusive answers. He who holds forth on the crippling effects of corporate taxes can doubtless mention particular situations where the thin margin of profit after tax has discouraged some people from embarking on an otherwise sensible extension to their businesses. Big shots in the mining industry will assert with some horror that high corporate taxes convert valuable ore into waste rock and it is probably true that some low

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grade bodies may be by-passed irrevocably because of the low residual profit after tax. An inaccessible stand of merchantable timber may be left to deteriorate into worthless old trees because there is not enough in it after tax to justify the risks involved in organizing a show to take it out. But for the high tax on profits it might have seemed worth doing.

65. There is some substance in these assertions and they deserve some attention but broadly considered these relatively minor instances of discouragement to action should not be blown up as a fundamental criticism of the system.

66. There are, of course, bad by-products of a tax of which it can be said in charging items to p & l that half the cost comes out of the government anyway. Also it is not denied that a cut in corporate taxes would give a real, if temporary, lift to business. It would greatly improve this so-called climate and the business world would with one accord agree that at last they had a Government in Ottawa that understood their problems. It would really help but it would take a courageous government to do it.

67. If the above conclusions are generally accepted for domestic business it might still be held that Canadian export sales are badly inhibited by our high tax on profits therefrom in competition with other countries. It seems, however, that business men the world over look on the corporate tax in their own countries in about the same way as Canadians do and that moving from domestic to foreign trade does not

alter the situation very much - they all still try to pass on the tax.

68. The implication of this situation is that although Canadian producers may not suffer much positive tax disadvantage in international competition, a lowering of our corporate tax would improve their competitive position abroad. It is against the rules of GATT to give tax incentive abatement on profits from export sales as such but a lowering across the board would help. The loss of revenue could be picked up through sales tax which does not apply to goods exported - a standard rule. This would seem to be good national policy for Canada. It would not make much sense, however, to those who believe that the incidence of the corporate tax is mainly on the shareholders and not on the purchasers.

69. In the U.S. the tax is 52%, in the U.K. it is 38¼% plus 10%. Generally in continental Europe corporate taxes are not appreciably less than ours. Canadian business men after trips to Europe, however, are inclined on return to hold forth pretty vigorously about the tax incentives that are offered to their competitors by governments abroad. Actually the incentives are very few and not too important.

70. After having considered the individual income tax and the corporate tax separately, comment might be made on those who in an analysis of our system bring together the combined effects of the two taxes. It is shown, for example, that 50% comes out of the dollar earned by the corporation and that another,

say, 70% (less 20% tax credit) comes out of the shareholder dividend, leaving only 25 cents to the original investor from the dollar of profits earned by his investment. This sort of assumed result is supposed to show that our system is pretty vicious and practically impossible. If this were the practical result in the ordinary case it certainly would be.

71. This however, seems scarcely a realistic way of setting forth the incidence of taxes on the ordinary investor who, say, decides to buy a few shares on the market. Here the adverse effects (if any) of the corporate tax on the profits of the company will already have been reflected in the market value of the shares. The new investor buys in on a yield basis of market price in relation to dividends after corporate tax. So it cannot be said that the corporate tax takes 50% out of the profit dollar earned on <u>his</u> investment. It was already out before he invested. As for personal income tax, if his marginal rate is 70% it will be 50% after the tax credit. However, if his corporation follows normal practice, it will pay out to the investor only about half the earnings his investment has bought, the other half will be retained and will add to the net worth and future income of his investment. If, as is to be expected, this growth is reflected subsequently in market values, our investor can realize on it at any time tax free. In effect he will have obtained without any tax at all the value of half the income from his original investment. He will have paid 50% tax on half the income of 25 cents out of the

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dollar earned on <u>his</u> investment, which is not too bad for a man in the $125,000 income bracket (the 70% rate starts at this point).

72. As for the person who participates in the original financing of a new venture (or the extension of an existing one) the calculation of expected return will always be on an after tax (corporate) basis. It is true that 50% of <u>gross</u> profit will be taken in tax but pricing will be set up so that the net profit will remain as the expected return on the dollar invested. It is scarcely true to say in the circumstances that the corporate tax cuts in half the earnings on investment when this half is already set aside as a reserve, as it were, for the government and allowed for in making the investment.

<u>The 20% Tax Credit for Dividends</u>

73. At this point in the analysis of the effect of taxes on the capital market it is perhaps appropriate to have a look at the 20% credit given to individuals on dividends received. This move in government policy was preceded by some decades of pretty outspoken criticism by students of public finance both here and in the U.S. against the so-called double taxation in our revenue systems, where corporate earnings were taxed and the dividends out of these earnings were again taxed in full when received by the individual. It had long been the inclination of officials in the Department of Finance to do something about this and with the funds available for tax cuts in 1949, the

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Government was persuaded to make a start and gave individuals a credit against their income tax bills of an amount equal to 10% of the dividends received from taxable Canadian corporations.

74. The main argument in support of this policy in Parliament was the removal of double taxation - mainly an argument of fairness. At the same time the corporate rate on small business was reduced to 10% on profits up to $10,000. These two measures combined had the effect of completely removing so-called double taxation on three-quarters of all taxable corporations in Canada (not, however, on three-quarters of total corporate profits). Today the credit is 20% and the low rate of 21% tax applies to profits up to $35,000.

75. The United States followed us some years ago with a very modest credit of 4%. However, the steam seems to have gone completely out of the strong sentiment which used to exist in the United States for this move. Possibly the loss of enthusiasm stems from the general realization that little, if any, double taxation actually exists, that the burden of the corporate tax is generally passed on in higher prices rather than back on the shareholder. In Canada the second move from 10% to the present 20% was never defended in Parliament on double taxation grounds. Rather it was declared to be encouragement for Canadians to acquire a greater stake in their own industry, to improve the market for equities and generally to be a good thing.

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76. It is always impossible to measure the results

of tax incentives. One can never know exactly how good they are or what they accomplish. Always, however, one can be sure that through their use most people will have been paid for doing something that they would have done in any case. But this is not necessarily very good argument against the tax device if it makes some appreciable headway towards the objective.

77. In this memorandum the 20% tax credit is firmly defended as a sound policy for Canada. It is openly nationalistic in its effects - the taxpayer gets 20% off for Canadian company dividends but nothing off for, say, U.S. Corporate dividends. God knows we all deplore the degree of foreign ownership of Canadian industry and this is a positive but modest step in doing something about it. It would be a great thing if there were a wider diffusion of stock ownership among industrial workers. Profit-sharing plans are good. Stock purchase plans to enable employees to acquire stock in their company considerably below market are excellent and the tax law practically turns a blind eye to these benefits. Stock option tax provisions are extremely generous in encouraging business executives to buy into the company they work for. Anything that encourages middle and lower income people to save and acquire tax free income from equities is all to the good. The 20% tax credit is a step in this direction.

78. It is asserted here without defending argument that a graduated income tax is an unfair tax, that there is no economic principle, nor any abstract or objective reasoning that can give justification for it. It is a

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political device that quite naturally is popular and this explains why it is followed and pushed to such absurd lengths. But this does not sanctify it. The reason for this statement of belief in the fundamental unfairness of our graduated tax is to supplement the argument that the 20% dividend tax credit is sound policy with the belief that giving tax relief to those on whom falls the burden of graduation in income tax, it makes the tax a fairer tax.

79. As for objections to the dividend tax credit, apart from some suggestions that it has not been too effective in accomplishing anything, is the fact that potentially it could give undue tax exemption. CCF members in the House have pointed out at times that a person with a $10,000. income could escape income tax completely because of the 20% dividend tax credit. The case taken is one where the person's total income was dividends from Canadian taxable corporations. If these dividends were from mining or oil companies whose shareholders are entitled to depletion the figure for totally exempt income would be about $12,000. The answer to this criticism is that it is doubtful if there is such a person in Canada. However, the objection still remains on paper as a possibility. It could be corrected by a simple provision in the law stating that in no case should the tax credit reduce a person's total income tax liability by more than X% (say 50%).

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irrefundable and abates personal income tax up to a point to wipe out duplication. In the British system, on the other hand, the individual income tax is irreducible and relief is given in respect to the tax paid in by the corporation. Accordingly, in the U.K. if the standard rate paid in upstairs by the corporation on behalf of the shareholders is higher than the shareholders' personal income tax on that dividend income, he can claim a cash refund. Canada side-stepped the almost impossible administrative problem of refunding corporate tax to shareholders (where the upstairs rate exceeds the downstairs rate applying to shareholders), by giving relief in respect of the duplication caused by the downstairs tax rather than that caused by the upstairs one.

81. The U.K. tax paid by corporations is in principle merely deduction of standard income tax at the source just as we have deduction at the source from wages and salaries. Likewise in the U.K. the shareholder has to gross up his dividends just as we have to gross up wages and salaries and take into income for tax purposes what we would have received had no tax been taken off by the employer. In Canada we do not require grossing up on dividends received since the corporate tax is legally a tax on the corporation and not on the shareholder. We take into income only the actual cash dividend received.

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as far as we can go without giving to the upper bracket people a relief from double tax greater than they in fact suffer (assuming the incidence of the corporate tax is on them). The explanation for this perhaps unsuspected result lies in the fact that in not grossing up the shareholder never has to take into income to be taxed at say, an 80% rate, the piece of income which he never receives because it is passed across to the Government upstairs in payment of tax on the whole profit of the corporation.

83. It was mentioned above that the increase from 10% to 20% in the tax credit was not presented to Parliament on grounds of removing the double taxation. There is no reason, therefore, why the credit might not be moved up beyond the present level purely as an incentive measure quite unrelated to any question of double tax. In the light of all the circumstances in Canada it is suggested here that a further upward move, say by 10 percentage points in the tax credit, would be amply justified.

Interest as a Deduction in Computing Profits for Tax.

84. Fairly closely related to the question of broadening share ownership in Canada and generally improving the market for equities is the question of the assumed inducement in corporate financing to issue debt rather than equities because interest on debt is allowed as a deduction in computing profits for tax purposes while dividends, of course, are not. Sometimes this point is raised in the form of a question. It is

stated that since the capital used in a business, whether equity or debt, is homogeneous and all of it produces the same profit return why should capital raised by fixed obligations be treated differently than share capital in calculating taxable profit? In brief, why should interest be allowed as a deduction?

85. Of course the complete and simple answer to this question is that the corporate tax is a tax on the profits of a corporation. It would be just as logical to ask why wages and salaries are allowed as a cost or why give capital cost allowances. In other words why not have a tax on gross receipts, a tax on value added or a tax on gross revenue rather than a tax on profits of the corporation. The corporate tax is a tax on the revenue remaining in the hands of the corporation after it has deducted all costs incurred in earning the revenue. Interest on borrowed money is a cost. Therefore it is allowed as a deduction.

86. Perhaps the question should be whether as a matter of policy it would not be better to disallow interest as a cost and reduce the corporate rate to the extent allowed by the additional tax revenue produced by the disallowance of interest. Annual interest charges (bond, mortgage, bank and other) against corporate profits of corporations in Canada are of the order of $600 million. At an average effective corporate rate for large and small corporations of 45% (Federal and Provincial combined), the disallowances would yield about $270 million which would permit a reduction of say, 9 percentage points in the average

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corporate rate.

87. It is assumed that this question of disallowing interest as a deduction is usually raised by those who believe that the present situation leads to distortion in the capital structures of companies, that it induces them into dangerous equity-debt ratios in their financing and that this is bad. It is suggested here that the so-called tax factor as a determinant in the set-up of most companies is greatly exaggerated. Surely if the gross rate of profit (before taxes) on total capital employed is above the borrowing rate for the corporation (and it usually should be) it will always be to its advantage to borrow as far as it safely can - quite apart from the question of tax calculations. After all there is such a thing as trading on equity or getting as much leverage as is safely possible on an equity position.

88. There may very well be situations where the interest deduction factor will swing a close decision between the issue of preferred stock vs. bonds but it would be a mistake to attach too much importance to this particular situation in assessing the overall picture.

89. This general statement about the inherent advantage to shareholders of a <u>prudent</u> degree of debt financing by their corporation of course needs a multitude of qualifications. Its reasonableness in any particular situation will depend on many things. It assumes that the securities of the corporation are widely held, that the common shareholders and bond

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holders are numerous and not identical persons. For example, it might be assumed that a small private company would almost automatically be financed almost entirely by bonds to secure the maximum interest deduction since if the controlling shareholder owned all the bonds he would never put his own company into receivership if at any time it could not promptly meet its paper obligations to himself. However, if the chief shareholder were in a high personal tax bracket he might not wish to be compelled to take the interest into income (as under the circumstances he would have to do) but would prefer to leave these earnings upstairs in the company to accumulate. Ordinarily he could draw out what he needed in the form of salary or else declare himself a dividend for whatever cash he needed and, incidentally, get a 20% dividend credit by having the earnings come out via this route. But again the net tax benefits may depend on whether and by how much the annual profits in his company exceed $35,000, the point at which the high corporate rate commences.

90. The financial structures of all wholly-owned subsidiaries (whether foreign-owned or Canadian-owned) will not be influenced at all by the interest deduction factor. In this situation, the tax saving in the subsidiary through charging interest payable to the parent is cancelled out because the parent is taxable on interest received but not on dividends received if the parent is a Canadian company. In the case of a subsidiary wholly-owned by a U.S. parent it would be to its disadvantage to be financed by debt if the U.S.

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tax rate were above the Canadian rate, which it usually has been in the past. Furthermore, the U.S. parent very frequently wants to plough back all earnings in Canada and in this case debt financing would be inappropriate. Thus, apart from the argument that over quite a wide range of companies, it is not the tax factor but other shareholder advantages that are responsible for debt financing, there is, in addition, quite a broad area where any assumed tax advantage is neutralized by disadvantages in other directions.

91. Perhaps one of the greatest objections to a policy of disallowing interest as a deduction is the unfairness it would inflict on small business men trying to build up a business with inadequate capital of their own and who have to finance by debt - mortgage, bond, bank or otherwise. One immediately thinks, for example, of the growing number of customers of the Industrial Development Bank as typical of the group who would be adversely affected by interest disallowance policy. The small business man with adequate capital resource of his own would have a distinct advantage over him who had to borrow to finance his business. Not good.

92. Always in tax policy matters changes from the status quo which in themselves might be good have to be discarded because of the disruptions, disturbances and the upsetting of legitimate expectations caused by the change-over. The disallowance of interest, even if it were good in principle, would probably, as a policy, founder on this rock. It is doubtful if any political government would be willing to walk into the

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uncertainties involved in such a measure. It could, of course, be worked into gradually, say one-fifth of the change-over in each of five years. But even so, the adjustments in the business world would be bound to be pretty dramatic. Assuming the disallowance would give revenue to allow for a 20% cut in the corporate rate, then all corporations with no debt would have their taxes reduced by this degree. Companies with a high debt ratio on the other hand would be severely penalized. The stock market would at once react, erratically of source, to these altered prospects.

93. Just for example, the tax liability of Bell Telephone (held by so many widows and orphans) would be substantially increased. Many shareholders would panic and dispose of their shares not knowing of the probability that the Board of Transport Commissioners would later get around to giving rate increases sufficient to offset the higher tax. This in turn would increase the telephone bills of the legion of Bell's customers and they in turn would have something to say to the Government about this.

94. It is not the purpose in the foregoing paragraphs to give too much emphasis to the purely political arguments against the policy but rather to indicate briefly the range of <u>purely fortuitous</u> gains and losses to shareholders and customers in the community through such a far-reaching change in tax policy. Fortuitous gains and undeserved losses of this kind in the community are both bad in principle. There would have to be very strong positive arguments in favour of

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disallowance of interest as an expense to justify the disruption it would cause. This memorandum bluntly states that none have been put forward so far that would come anywhere near giving warrant for the policy. Not that it is relevant to the argument but so far as is known here, no other country has ever followed a policy of disallowing interest as a deduction in computing profits for tax purposes.

Taxation of Capital Gains

95. The two countries with which Canada is most closely associated both tax capital gains. In the U.S. this has been the practice from the early days of income tax. The U.K. has ventured into this troublesome field only recently and only in a limited way. In view of the potential effects of this kind of taxation on capital accumulation and the operation of the capital market opinions regarding it might be appropriate in this memorandum. Following is some analysis of various points to consider in assessing the expediency of a tax on capital gains in Canada.

96. We do not at present and never have taxed capital gains in Canada. The Courts have seen to it that our Income Tax Acts have taxed income only (in their opinion at least, which is law). Accordingly, this is a safe statement for a layman to make. However, in recent years, there has been a considerable volume of assertions that in fact the administration has pushed assessments pretty deeply into the field of gains on capital transactions.

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97. What in fact has happened is that the Department, after years of turning a blind eye on certain transactions started issuing assessments against people who had not been reporting certain gains as income. Mainly the Department concentrated on real estate, second mortgages and various miscellaneous deals. They have rather meticulously avoided the general field of dealings in securities (except some promoter type in-and-outers) which is next to impossible to sort out satisfactorily under an income tax law. In this, the Department has followed pretty closely the U.K. pattern of income tax administration and our Courts have leaned heavily on U.K. jurisprudence and judicial reasoning.

98. As an approach to the question of the expediency of a capital gains tax for Canada, one might take a critical look at the usual economic arguments advanced against such a tax.

99. We have all heard many times in discussion of a tax on capital gains, the so-called argument that in a new, growing, immature, capital-importing and underdeveloped country, such as Canada, struggling for the rapid development of our boundless natural resources with which Divine Providence has so richly endowed us, a tax on capital gains would be a very bad thing. This sort of stuffy assertion rarely if ever carries with it any supporting argument. By itself, it sounds so impressive that no one seems to have bothered to question it. Mostly this is utter nonsense.

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the argument would be that because a person would be liable for a tax upon the excess of the selling price over the original cost to him of a piece of property, he would be disinclined to enter into the transaction; that he would be discouraged from undertaking various business enterprises and ventures, all of which would have a stultifying effect on the business world; that enterprises which should be undertaken would be foregone because of the possibility that at some future time there might be a tax on gains from the sale of some or all assets. This does not sound very convincing. Surely for most people embarking on a serious business project the least of their troubles would be the question of tax on the eventual sale of business assets <u>at an advantage</u> some time in the future.

101. With a tax on capital gains on the books just as many fishermen would build or buy boats or ships and go down to the sea in them; just as many farmers would buy farms, machinery and equipment, put up buildings and go on labouring from dawn to dark. Who will suggest that the number going into the wide range of manufacturing industry would be deterred from doing so because of a tax in the event that they subsequently sold some of their assets at an advantage some time thereafter? Who would argue that activity in the broad fields of merchandising, transport, the service industries and all the host of many small enterprises that make up the business life in the community would be less than it now is because of a tax on capital gains? Most people do not go into business with the idea of

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selling out again shortly.

102. As for the natural resources industries, it is not easy to believe that opportunities for profitable development would be passed up because of a capital gains tax. Who would say that the Knobb Lakes, Wabushes, Kittemat-Kemanos, Thompsons, Yellowknifes, Blind Rivers, the Leducs, Redwaters, Pembinas would not have appeared, and just as soon, if there had been a tax on capital gains in Canad?

103. In considering a tax on capital gains most of us, it seems, are inclined to think in terms of its effects on individuals qua individuals. One rarely thinks of its impact on corporations. However, by far the greater volume of business that keeps our country going today is done by corporations. Decisions will, of course, be made by individual officers of the corporation. One ventures to suggest that management decisions for the acquisition or disposition of properties and assets in the ordinary course of carrying on the main business of the corporation would rarely, if ever, be influenced by a reasonable tax on possible gains from a subsequent profitable sale of corporate property.

104. To this point an attempt has been made to set the problem in perspective. The first conclusion then is that the introduction of a capital gains tax would scarcely cause a ripple over the vast sea of ordinary business transactions and economic activity in Canada, that things would move along about as they are now doing. Gross National Product would be about the

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same. The heavens would not fall. But, of course, many would scream to high heaven that disaster was upon us.

105. It might be held that the above analysis, which has looked broadly at the business world as a going concern and has concluded that a capital gains tax would not disturb matters very much from the present pattern, is too simple and too superficial in its approach, and that really important detrimental effects would work themselves out beneath the surface of things. Possibly, it would be argued that although the entrepreneur would still be full of beans and would be enthusiastic to proceed with his plans for a profitable venture, he would not find it so easy to get financial support for his project, that a capital gains tax would have scared away a significant volume of capital that would otherwise be willing to join a venture having good growth prospects.

106. It is perhaps impossible to attempt an exact generalization about the over-all financing situation in which new business ventures secure their funds. Broadly, however, it might be said that there are two main sources of venture capital that might be looked at to assess the possible effects a capital gains tax might be expected to have, e.g., (a) the stock market, and (b) monied or well-to-do individuals or groups of individuals who provide backing for more or less closely held enterprises.

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107. Speaking as one quite out of his depth in these matters, one might still venture the opinion that

a moderate tax on capital gains, say, 10%-20%, or even 25%, would not have a very significant effect on the dollar volume of funds flowing into stock markets in Canada today if losses were allowed. In the first place there is the large, solid, supporting group whose main object in buying securities is to secure a relatively constant flow of income from stocks with the intent to hold, who should not be deterred from continuing to invest because of a tax on subsequent eventual selling out. They could, of course, be expected to protest bitterly and predict the ruination of the country, but one can doubt if they would cease investing the same volume of funds in equities.

108. Another very large group supporting the market is made up of investment trusts, pension funds, life insurance companies, universities and charitable institutions generally. They would all be unaffected by a tax on capital gains. It is not known what proportion of the market for equities is represented by the groups just mentioned, but we all know that it must be very substantial indeed.

109. One cannot be too sure how a capital gains tax would affect that very numerous, hardy and hopeful perennial group of souls who, operating a bit breathlessly on tips and rumours, venture mightily into the market with a few hundred dollars or m re, usually in mines and oils where really startling and exciting things can happen any time. One can guess, however, that most of them would be extremely reluctant to forego their noon visits to brokers' offices, the pleasure of

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telling their friends how well they've done in the market, and the exhilaration of being a knowing sort of capitalist fellow, full of wisdom about this and that in the business world. Then too, one should always remember that if capital gains are taxed, capital losses may be deducted. This fact, one can be sure, would free most of the amateur in-and-outers from any year-end liability for capital gains tax. Finally, regardless of how this group would react, it is unlikely that these small operators contribute very greatly to the total of funds left in the capital market for economic development of the country.

110. As for the substantial knowledgeable operators who are in and out of the market with considerable regularity it is not to be expected that they would give up because of a moderate tax. One does not hear of a scarcity of this kind of venturesome money in the U.S.

111. The significance of the second broad source of outside venture capital, the moneyed, well-to-do individuals, is harder to assess. These fortunate souls may take the initiative in seeking out opportunities for placing fairly substantial blocks of funds or, perhaps more frequently, they are approached by others of the same general cult, but more of the promoter type with a sales talk. These latter characters may be willing to let big money in, give it the opportunity to participate in something that is being built up or put together. Undoubtedly this group make a lot of very useful things happen that but for

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their energy, ingenuity, venturesomeness and general pushiness would not otherwise take place in the business life of the community. Some person always has to have ideas and take the initiative to start things moving. They are a valuable asset in any country.

112. Granting, however, that as a total the funds placed in industry by moneyed individuals in blocks through direct contact with persons taking the initiative in a venture is quite substantial, it does seem that we have to look a little more closely to see whether generally their idea is mainly to get in and out again fairly soon and make a quick capital gain, or whether they plan to hold on somewhat indefinitely to reap the benefits of the venture through a flow of income with growth prospects over a 5, 10 or 15 year period. It seems reasonable to assume that the relatively big money fits into the latter group, that is, that it tends to stay in for eventual results, and that the in-and-outer, the promoter type of restless money, while important in its way, is not so significant in the broad economic development of a country.

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115. To be impressed by this fact, one merely has to look over the giants and even lesser operating units in the fields of manufacturing, transport, public utilities, marketing, and so on. Particularly, is this evident in the development of natural resources. The mining industry today, for example, is dominated by empires. They do their own exploring, developing, and constantly are on the look-out for likely new significant ore bodies. In the oil and gas industries, the big money flow is through a handful of large, integrated companies with an international flavour. Pulp and paper companies have to be large in order to operate at all. This is no place for the individual with a few hundreds of thousands of dollars. Old-timers and independents in the natural resources fields may deplore these facts, but they cannot be disregarded in summing up the situation. The point of all this is that the investment activities of these corporations would be completely unaffected by a capital gains tax. Incidentally, mention might be made here in passing of the extent to which new capital investment by corporations is financed out of retained earnings, and, accordingly, is not dependent in any way upon outside

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investor decisions for this supply of capital.

116. There are quite a number of people in this country who claim they are in favour of a capital gains tax and offer an inverted sort of argument related to what is suggested above. Their position is somewhat as follows: Canada professes not to tax capital gains today. However, the uncertainty in the law through lack of clarification in some directions is such that people are deterred from proceeding with important business transactions because of the fear that they will be held by the Courts to have entered into an "undertaking" or "an adventure or a concern in the nature of trade". If this horrible fact can be proven against them, then the alleged capital gains will in law be <u>profits</u> from a business and taxable in the hands of an individual as regular income at full graduated rates, possibly as high as 60% or 70% or more. Accordingly, it is argued, we should have a capital gains tax under which this kind of gains would be taxed at the relatively low capital gains rate, which would not, it is held, deter the person from going ahead with an undertaking of considerable importance to the community. He would have certainly.

117. This proposal, however, does not really touch the problem. The mere introduction of a tax on capital gains <u>as our present law sees them</u> would not at all cure the situation just described. The gains just referred to, which, if held by the Courts to be <u>income</u>, would still be <u>income taxable at graduated rates</u> even after the introduction of a capital gains tax, <u>unless</u>

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simultaneously the present definition of income were changed. The transactions in question could only be freed from graduated tax by re-defining what constitutes carrying on business. There would still remain the problem of drawing a line in this very awkward field where carrying on business is essentially a matter of degree and is not absolute. The problem of uncertainty would continue to exist, even under the most skilfully worded amendment directed towards a less inclusive definition of income from a business.

118. Those who suggest the general capital gains tax on the grounds mentioned above - in effect to improve the capital market - are fumbling pretty badly. There is obviously no point whatsoever in imposing a capital gains tax across the board - the U.S. type - to cure the marginal problem they are concerned with. This is simply asking for more trouble. What only is needed are words or phrases which in a negative way would declare that doing certain things does not constitute carrying on business and giving rise to income.

119. This may sound like a very fruitful approach but it has been tried and found to be pretty difficult. Section 83(3) of the Income Tax Act does something along this line to free from tax the gains from grubstaking mining prospectors. Probably no one is very happy about this provision. It has given rise to a breed known as Bay Street prospectors.

120. It is impossible to know how many of these individual promoter type transactions are inhibited by the fear of graduated income tax or how important they

simultaneously the present definition of income were changed. The transactions in question could only be freed from graduated tax by [illegible] carrying on business. There would still remain the problem of drawing a line in this very awkward field where carrying on business is essentially a matter of degree and is not absolute. The problem of uncertainty would continue to exist, even under the most skilfully worded amendment directed towards a less inclusive definition of income from a business.

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119. This may sound like a very fruitful approach but it has been tried and found to be pretty difficult. Section 83(3) of the Income Tax Act does something along this line to free from tax the gains from grubstaking mining prospectors. Probably no one is very happy about this provision. It has given rise to a breed known as Bay Street prospectors.

120. It is impossible to know how many of these individual promoter type transactions are inhibited by the fear of graduated income tax or how important they

are. These promoter fellows, of course, can be an extremely valuable asset in the economic community. It would be too bad if many were restrained through tax. However, it almost goes without saying that the blame placed on the tax in all back-room discussions on this subject - which is where most of them take place - will be gr atly exaggerated. It could be just a relatively small fringe problem, deplorable but not too fundamental.

121. There are two more points about a capital gains tax that might be made in this section dealing with economic arguments pro and con. The first has to do with the amount of capital that, as it were, would be taxed away from the capital market by such a levy. There has been some talk recently from the political Left that a capital gains tax could be used to finance more social security. This is a pretty extravagant piece of election patter. Possibly a capital gains tax in Canada would produce \$80-\$100 million a year. It would not be a big revenue producer. It is not important even in the United States revenue system. As a matter of fact, in the United States it has been said that the capital gains rate is used as much for giving relief from higher normal rates as it has for imposing extra tax.

122. In good years in Canada the total amount of capital invested is something of the order of \$9 billion. Thus an amount of about 1% of this total might be taxed away. Of the amount taxed away let us arbitrarily say that perhaps one-half might be from transactions in property in personal use rather than from property used

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in business. This would mean then that the capital gains tax had depleted capital otherwise destined for economic or productive growth by something of the order of one-half of one percent. This is not a figure large enough to cause alarm in anybody's heart. It can be agreed then that a capital gains tax would not cut deeply into the national capital account.

123. The second point which might be made against those who fear drastic economic effects from a capital gains tax is to invite them to look south of the border where such a tax has been operating for many decades - God help them. Economically, they seem to have done very well in spite of it. The non sequiturs in this as argument are to be ignored. The fact is merely mentioned in passing.

124. From the above rather sketchy analysis it is fair to conclude that the usual claims about the dire effects on the business community of taxing capital gains are quite immoderate to say the least. They are another example of the sort of easy exaggeration that almost automatically flows from emotional expressions on tax matters. The main objections to taxing capital gains are not to be found in the alleged disastrous effects on the capital market but elsewhere. These will now be explored.

125. First of all, no government in Canada should consider for a minute a tax on capital gains measured in dollars until the value of these dollars has been firmly stabilized, that is until we can be assured that the danger of inflation has been clearly wiped out of the

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picture. With inflation, a tax on so-called capital gains becomes a very unfair and arbitrary tax on capital itself for those compelled at various times to realize on the accrued increase in the dollar value of their property. The Canadian dollar is worth less than half of what it was in 1939. For purposes of illustrating the point being made, let us assume that a person bought a house in 1939 for $10,000. Today if the house has moved up in value corresponding to the fall in the value of the dollar, it would be worth something over $20,000. In selling it for that upon having to move to take a job elsewhere, one would be liable for tax on $10,000 plus capital gain and would, accordingly, find himself short of the funds needed to purchase in 1962 the same sort of house he just parted with. Of course, this sort of situation can be alleviated by making exceptions as they do in the U.S. if the taxpayer re-purchases a house within twelve months or has one rebuilt within eighteen months. In the U.K. they exempt sales of houses occupied by the taxpayer. But this is where complexity begins to take over. The unfairness of a capital gains tax where inflation operates cannot possibly be cured by creating exceptions. The law would completely bog down in utter complexity, administrative impossibility and floods of litigation.

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revenue. If the government needs an additional $100 million of revenue (and it badly does) there are many better and fairer ways of getting it than imposing a general tax on capital gains. A capital gains tax imposed say, in 1962, to apply then and thereafter would require everybody to establish somehow, somewhere, the value of all his property piece in that year so that 10, 15, 20 or possibly 50 years hence he could declare and prove that upon sale of the property his capital gain was exactly so many dollars, no more, no less after, of course, having kept track of all such things as taxes, depreciation, maintenance, repairs and so on for all the intervening years. Surely the more statement of these requirements is sufficient to make it obvious that this would be a very very troublesome sort of tax for both the government and the tax-paying public.

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127. The answer given by U.S. experts that in their country it works is not good enough. It is well known that the U.S. tax law and its administration calls for more complex artifical and unreasonable burdens of tax compliance than any government in Canada would ever dare to try to impose or inflict on our long-suffering public. The insidious part of it is that in principle the capital gains tax is very simple but, in fact, the complexities in it are quite appalling.

128. It can be said with some truth that a tax on capital gains is merely an estate tax in a hurry. It taxes capital gains when they are realized instead of waiting to tax the accumulation at the end of the road to pick up revenue through a tax on the total estate. Furthermore, looked at analytically, it is quite anomalous to build a tax on capital gains into and make of it an integral part of a graduated tax on income.

129. Income tax is a tax on a flow of income. Being a flow it has to be measured by reference to a period of time. We use an arbitrary twelve month period. Personal exemptions are then related to the length of this accounting period. If the accounting period were twice as long the personal exemption would have to be twice as large. The graduated rate structure is tailored to fit the length of the accounting period, that is, to the amount of income flow that is lumped up for tax purposes. The present rate structure applied against twelve months of income hurts badly enough but applied to two years of income

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the result would be simply excruciating. It is the height of absurdity to try to inject capital gains logically into this income tax framework when the gains realized in any year may have been accruing for only a few months, one year, five years, twenty years or perhaps even forty years. It just does not make sense. So the bright boys have to start tinkering. A line is drawn between short-term and long-term gains. "Long" used here may be two years or forty years - both periods are long.

130. A graduated rate structure applied to these two long-term lumps of gain would be unfair to the taxpayer and so he may be given a choice between a flat rate tax or taking only one-half of the gain into income. And so it goes, trying to fit square pegs into round holes. If for any reason not yet on the horizon in Canada capital gains simply <u>had</u> to be taxed, the best way would be to put on a flat rate excise tax and make no pretense whatsoever at associating it with the income tax structure. One hastens to add, however, that all the complexities of valuation and establishing a base point would still be encountered under an excise tax on capital gains.

131. Demands for a capital gains tax are usually heard from the political Left. In our Parliament, members of the old CCF party frequently have urged the Minister of Finance to introduce one. Usually there has not been much of a head of steam behind these requests and little if any argument ever accompanied them. Nor, indeed, has any Minister of Finance ever

deigned to give a systematic reply to these proposals. Essentially, the question is whether in a tax system which must always be held to be fair and reasonable, recognizing the principle of taxation according to ability to pay, it is fair to allow capital gains to go untaxed at the time of realization.

132. Trying to pass judgment on the fairness or reasonableness of any proposed course of action in taxing is always a pretty frustrating sort of business and it is particularly fruitless to try to pass judgment on the question of the fairness of a particular kind of tax taken by itself without looking at all the other kinds of taxes, Federal, Provincial and Municipal. That is, we should look at the total complex of in-payments to governments in Canada and at the same time have regard to the annual flow and distribution of out-payments and services from the government in this day of the Welfare State. A few facts and opinions on this question will follow.

133. In the first place, it can be stated as a general proposition that capital gains if unspent and not subsequently lost are taxed under the estate tax on the taxpayer's death. A Minister of Finance once mentioned this as an important reason for the entry of the Federal Government into the death duty field ! Some people, of course, - to what extent is not known - spend their capital gains in most un-bourgeois-like fashion instead of saving them and where this happens capital gains will not be taxed on their death. If, however, they spend them instead of allowing them to

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accumulate, they will have run into Federal sales tax of 11% on much of this expenditure as well as provincial sales taxes at varying levels in most directions where the money was spent. Miscellaneous taxes of this sort can add up to quite significant amounts and they are avoided by people who save their gains for their old age or their descendants. It might be mentioned in passing that in the United States there is no general sales tax at the federal level on consumer goods expenditure corresponding to that in Canada.

134. Even assuming that the money made on capital gains never bore any tax whatsoever, it would still not necessarily mean that there was any unfairness in the tax system. If by far the great majority of people own some property and therefore have occasion to make some capital gains now and then there would be no unfairness in the system through not taxing anybody on this sort of gain. A good example of this principle is seen in the exemption from tax of all the earnings on savings accumulating in the life insurance field. There are probably about six million life insurance policies in force in Canada, that is, practically everybody has one and there is, accordingly, no real unfairness in allowing income accumulations in these directions to go untaxed.

135. Very few people in Canada today can be said to be living below the poverty line or are completely propertyless. One has merely to stroll through the so-called slum areas of large cities and

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observe the forest of television aerials outlined against the sky or to observe the parking space needed outside the modern industrial plants to accommodate workers' automobiles to be thoroughly convinced that our society is not one which divides itself into the haves and the have-nots. Government assistance in the field of housing is fast making property owners of all who in the terminology of some people would be called the proletariat.

136. The recent introduction of a limited capital gains tax in the U.K. is quite openly a political manoeuvre by the Conservative Government. The Chancellor of the Exchequer admitted that it had little, if any revenue implications, that it was mainly for what he regarded would mean greater equity in their tax system. Frankly, it was a piece in the Government's attempt to offset the unpopularity of pay-pause policy. In the U.K. they have to pay far more attention to what might be called the class warfare angles in tax policy. The impression had got around in the U.K. that quite a large number of people were living well off of stock market gains (one wonders what would be said now in the light of the losses taken by these people in recent months). Also very profitable transactions on a wide scale in real estate had been escaping tax through the incorporation of land companies and the sale of shares in them in a block to the purchaser (Canada has been far more effective in dealing with real estate transactions than they have been in the U.K.). So

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to show that they were on the right side with the masses, the U.K. Government blundered into this field with pages and pages of complex illogical law.

137. It would not be sensible to regard the recent U.K. entry into this field as a basis for arguing similar policy for Canada. It is fair to say that the U.S. practically stumbled into taxing capital gains. There is no special law in that country imposing this kind of tax. It came about entirely through an interpretation of the Courts of a definition of income almost identical with that contained in our original income tax Act. Whether apart from this turn of events, and the tradition built on it, the U.S. would today decide as a matter of policy to tax capital gains is hard to say. Many European countries have a limited form of taxation on capital gains mainly, however, applying solely to corporations.

138. Essentially the position taken in this memorandum is that the economic arguments pro and con are not too significant. The fact is this tax is a very poor way to raise revenue in that it is too complex and too troublesome for both the taxpayer and the government. Furthermore, it does not seem that over-all fairness in the tax system as a whole demands it. It was stated above that the personal income tax at graduated rates, while not seriously undermining the incentive to save and invest does cut very drastically into the ability to save and invest by those who might be expected to supply a

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great deal of capital for investment in Canadian industry. A capital gains tax would similarly cut into the supply of capital available for re-investment. It would worsen the already bad situation created by graduated income tax.

Tax Incentives

139. It is so much the fashion these days to advocate tax incentives as the generating force needed to revitalize the community and restore growth to a prosperous but uninspired state of affairs in our business world that a general survey of the tax structure would seem quite incomplete without comment on this philosophy.

140. In the light of views stated earlier in this memorandum it cannot be claimed that this topic has too much direct relevance to the terms of reference of this Commission. True, a healthy growing economy in a fair state of equilibrium has less problems in the field of banking and finance than one in the doldrums with uncertain prospects. The so-called psychological factor can be of some importance. However, it has been suggested earlier in this memorandum that personal income tax does not, on balance, lessen very much the urge to work, get ahead and improve job status; that it does not discourage saving and investment very much; that the corporate tax has little more adverse effect on the economy than would a sales tax (to give the same volume of revenue) applying to the products and services sold by corporations. It is submitted, however, that the

great deal of capital for investment in secondary industry — a capital which the more fortunate [illegible] into the hands of [illegible] [illegible] by graduated income tax.

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pattern of downward re-distribution of income generally through all ranges of income effected through welfare legislation financed by proportional and graduated taxes, has a very real effect in limiting the domestic supply of capital available to build up an acceptable status for an independent national economy. Nevertheless, it might be useful to the Commission to have before them a view on the general importance of this alleged cure-all tax incentive.

141. The faith of the general public in gimmicks is amazing and it verges on the pathetic in this field of tax policy. It does not follow, of course, that because the existing tax structure is not in itself to any extent a positive deterrent to personal effort, business activity, saving and investment that certain devices would not have beneficial net incentive effects. It still could happen that relief from the standard burden would induce people to do things they would not otherwise go ahead with! This is the basic principle of incentive legislation.

142. All in all, we in Canada have been a bit unlucky in the outcome of tax incentive gadgets in the past. In 1938-39, we introduced a 10% tax credit for new capital investment to get things going a little faster at the end of the bad thirties (the U.S. is deciding about now to try the same thing). We got it nicely going when the war came along and made it all very unnecessary. The cost of that one pretty much went down the drain. In wartime, we introduced forced

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savings to help lick inflation and to build up a fund for repayment at the end of the war to offset expected depression. Instead of depression, of course, we were still fighting inflation and the out-payment of the forced savings merely aggravated the problem.

143. We offered double depreciation for new investment in a two year post-war period when, as it turned out, the overwhelming excess of new investment was already a major national problem. In the Korean episode we disallowed normal depreciation for a three year period on unessential capital expenditure in order to slow it down. Shortly thereafter, it seemed that this was not needed so the government relented and said, in effect, you may now take the writeoff which we told you you could not have when you made the investment. This served notice, as it were, that if in future we try this sort of thing again, you cannot be sure that we will really do what we said we would.

144. Recently, the Government has dabbled in this field. In 1961, the provisions which were introduced to induce industry into depressed areas and new products were merely gestures with no significant leverage in them! In 1962, provisions for tax abatement on profit from increased sales and the incentive for research expenditure may have some real substance.

145. The tax abatement on profits from increased sales in manufacturing and processing should have some effect in stimulating export trade. If all firms in an industry try to increase their <u>domestic</u> sales

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they may not, as a group, add much to total sales or increased employment in Canada. However, there is unlimited scope for pushing into the export market for some products and this type of provision being general in its application, does not offend against GATT. But the great obstacle to whole-hearted approval of this rather typical sort of incentive is its complexity. In principle, it sounds good and simple. However, Government officials, tax lawyers and accountants, generally are frankly appalled at the prospect of pages and pages of complex and arbitrary law and regulations that will be necessary to make it work. It cannot possibly work fairly and there is some doubt that it can be made to work at all. The scope for manipulating and juggling is a bit awful.

146. Just for example, a U.S. parent may decide that it would pay to put some of its own export sales through its Canadian subsidiary. It could sell to it and the sale to the foreigner could be made in the name of the Canadian subsidiary without the goods ever entering Canada at all for export. This move could, of course, be very simply blocked by providing that the goods have to be produced in Canada. Then the next question is how large must the "Canadian content" be. Does the law have to get down to a "value added" in Canada as the legitimate base for measuring increases. This is just an example of the sort of thing that will make life difficult and miserable for Government officials and profitable for lawyers and accountants when this proposal becomes law.

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The main and very real difficulty in the scientific research incentive is definition. To have much leverage, it will have to include the exploratory and development work in applying a scientific knowledge to industrial processes, pilot plant expenditure and so on. Some very difficult lines will have to be drawn here. For example, pilot plants at times are kept in operation for regular industrial production. This attempt to encourage research is more in the nature of a long-run policy and cannot have much immediate effect on business and employment. While it would be good to have more industrial research done in Canada, it is quite natural and probably more economic that for subsidiaries the research should be carried on by the parent company abroad. There are many cases now where there is no charge against Canadian profits for research carried on by the parent abroad. The benefits all come free. The same is true for much advertising. Switching research expenditure from the U.S. to Canada will not be all gain by any means.

148. As for tax incentives generally the British form of investment allowances seem to be the best so far conceived and they have the great advantage of relative simplicity. They simply allow an additional write-off for expenditure on depreciable assets, i.e., some percentage more than was spent. They can be given to all taxpayers generally or to selected industries that need encouraging, such as shipbuilding for example; or they can be given for particular areas

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(such as the Atlantic Provinces). They have far more leverage than accelerated write-offs of actual expenditure which, in effect, offers only an interest free loan of tax money for a few years. This can help the cash position of the less well fixed companies but offers little financial benefit to the credit worthy.

149. For one who has been paid for many years to produce ideas for the tax system, the almost invariable result of attempting much refinement in taxing is disappointment. No one who has had much experience trying to build useful and workable incentives into tax law should be very enthusiastic about them. It seems to be almost inevitable in the case of each experiment that at some stage he will admit that had he known in advance the difficulties the measure would encounter, the unfairnesses it would create and the unforeseen manipulation it would afford, he would never have had the courage to propose it.

150. Good as some tax incentives may appear to be, the question always arises - and can never be answered with certainty - whether it would not have been better for the economy as a whole if the time and money (loss of revenue) spent on gimmicks would not have been better applied to a rate reduction for industry generally. The view here is that <u>as a general rule</u> it would.

<u>Fiscal Policy</u>

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Fiscal Policy

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ness of Central Banking in Canada, to determine how successful the Bank has been in its attempt "to mitigate by its influence fluctuations in the general level of production, trade, prices and employment" and to recommend any changes that they think might help. There are those, of course, who believe that fiscal policy can be equally, if not more effective than monetary policy in performing these functions which Parliament assigned to the Bank of Canada. This memorandum offers comment on the validity of this claim. Briefly stated in advance it does not agree with the proposition.

152. Over the past few decades, opinion has varied greatly regarding the relative importance of the two instruments for control over the economy, monetary policy and fiscal policy. It is fair to say that during the thirties the main reliance was on monetary policy. There was some disillusionment when it became so obvious that the utmost in easy money policy could not induce recovery, that even a negative rate of interest would not bring on economic activity if other conditions were not favourable. This led to a groping for and the emergence of fiscal policy as the right answer to many things. The experiment with tax credits for new capital expenditure mentioned above represented the beginnings in Canada of a new line of thought. The 1939 and 1940 War budgets revealed a pretty clear philosophy of the importance of taxing in relation to business activity and employment. As the War period developed taxation

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was an important and probably fairly effective supplement to price control in containing inflation.

153. Paralleling this rise in favour of fiscal policy was the further decline in the prestige of monetary policy. Central Bank functions during and after the War were almost completely prostituted and dedicated to the greater glory of bond salesmen. We had reached a stage where it was practically an offence unto decency to let a Government bond fall below par. Recriminations poured in from all sides when finally this happened.

154. Utter faith in fiscal policy in post-war years reached heights that now, in retrospect, appear little short of absurd. National planners with a gleam in their eye went completely overboard on the idea. Centralization of power in Ottawa was the main theme. Federal-Provincial tax agreements were to be the keystone of the new structure. The Welfare State was well advanced on the drafting board. It was to provide for stabilized purchasing power. Shelves of public works were to be built up. Provincial and Municipal capital expenditure programs were to be controlled by degrees of cost-sharing by Ottawa. Economic activity was to be carefully controlled. Growth was to be assured and continuous, Excessive booms, depressions and recessions could not happen again. The golden age was about to dawn.

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was to give a basic stability to consumer purchasing power. The poverty reflected in the low level of retail sales in the early thirties would not be allowed to happen again. If recession so much as reared its head, taxes would be cut to increase purchasing power and recession would recede. If activity got too hectic with excess demand starting to pull up prices, taxes would be increased and with lessened demand, the price rise would fall back into place. Just about like that.

156. It is inappropriate here to try to record all the various reasons for the decline and fall of this rather naive faith in fiscal manipulation. It will suffice to say that Department of Finance officials one after another admitted that in their enthusiasm for building a brave new post-war world they had been more than a trifle over-sold on the part fiscal policy could actually play in the Canadian economy. Dr. Clarke, the Deputy Minister of Finance during this period, to the time of his death from over-work, never did openly concede defeat or admit disappointment.

157. Shelves of public works with projects to be pulled down at the appropriate moment were for various reasons found to be impracticable. Nothing ever came or, in fact, could ever easily have come from the idea of formally controlling Provincial and Municipal capital expenditures, saving them up in prosperity and pulling the plug when times were sluggish. Actually, as it has turned out, housing policy and the activities of CMHC (one of Dr. Clarke's

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enthusiasms) have far exceeded in influence on the economy anything that could possibly have been achieved by regulating public works. But in this field of housing, the influence of policy seems mainly to have been pretty consistently on the side of more and more (since there has been chronic unemployment for years). So that with this powerful instrument one cannot too readily accept the opinion that housing policy will ever be used by a political government as a stabilizer but always as a stimulator in both good times and bad.

158. Undoubtedly welfare expenditure has added greatly to the stability of retail sales in Canada. It is amazing how in the past decade the volume of consumer buying has refused to follow the ups and downs of GNP, industrial production and employment. This is all to the good but welfare expenditure as a piece of fiscal policy can never in any sense be regarded as more than a one-sided device. It only operates one way, always up and never down. With the Parliamentarians ever the faith endures that more and more is good and from the point of view of getting elected, this is probably true since from the way welfare is financed the majority always get something for nothing.

General Effectiveness of Deficit and Surplus Financing

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and impressions. The subject needs a book at least.

160. To begin with, it is next to impossible to make generalizations that will apply to all countries. It does seem, for example, that in the U.K. deficits and surpluses on budget account are regarded as of great direct significance in the economy. At least the sophisticated economic analysts seem to argue policy on the assumption that effects of almost mathematical precision on GNP, employment, balance of payments, will follow from a budget deficit or surplus position of a given amount. One cannot know without considerable study how correct these assumptions are. Perhaps on their tight little Island things do work out pretty much as they predict. But it would, of course, be completely wrong to assume that the same sort of policies which are effective in the U.K. would necessarily have any significant similar application at all in Canada.

161. Coming now to the United States, any conclusions here are bound to be pretty much guess work. There is no clear-cut record in this country that can establish the soundness of running deficits to revive a faltering economy or of budgeting for substantial surpluses to impose restraint. No one would, of course, deny that a very large deficit would give some stimulus to business in certain directions. But even so, an extreme deficit position could easily cause the sort of distrust that would seriously reduce new capital investment, particularly if it were the Democratic Party that was responsible

for the policy. In the past there has, of course, been much theoretical discussion of the general virtues of cyclical financing but evidence of the practical effectiveness of it is a bit hard to come by. It seems fair to say that from a high point of unproven faith in cyclical budgeting of, say, a decade and a half ago in the U.S., there has been until recently a steady decline in support of gunshot blasts of excess spending or general across the board tax cuts as a sound method of support for a lagging economy. Certainly there has been greatly lessened support for this technique as a cure-all for general unemployment. The kind and degree of unemployment on this continent in recent years seems to call for something a little more specialized by way of remedy than spending in excess of taxing in the National Budget.

162. In the U.S. in the last year or so there seems to have been pretty widespread renewal of faith in the policy of spending the nation into prosperity, endorsed even by the Chamber of Commerce. Specifically, this excess of spending would be achieved by means of a tax cut across the board - corporate as well as personal, high as well as low bracket. One reads very little by way of analysis of how the expected desirable effects will work themselves out but the most common, simple conclusion seems to be that taxes are too high and are holding back business and that a general cut would give a boost to economic activity. This, of course, is pretty inadequate one-sided

reasoning and there is not much future in it as a policy unless something is done about total spending or re-arranging the incidence of the tax structure.

163. There is in U.S. government circles today a group of economists who have a highly developed horror of the wastefulness for the nation of unused or inactive resources - plant equipment and labour. They seem to believe that $50 and even $75 of pump-priming is worth it if it induces an increase of $100 in GNP. But this leaves unsolved the very practical problem of eventually getting the $50 or $75 back into the Treasury some time because the increase of $100 in GNP will have gone into private pockets. To be successful, a little bit of pump-priming should produce an increase in GNP, such that additional revenues at the lower rate of tax will more than restore the balance in the Budget. That this will be the final outcome in any particular set of circumstances is pretty hard to prove or even assume.

164. The insidious thing about tax cutting or excess spending for speeding up business is that it usually will be to the short-run political advantage of the Party in power to have a try at it and there are plenty enough respectable economists to be quoted in support of the policy. It is not so easy for the same political government to maintain taxes or increase them in times of full employment of national resources in order to achieve a budget balance over a period. It is doubtful if this has ever happened in the U.S., or indeed ever will happen.

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165. Furthermore, it is extremely difficult to separate in the U.S. pure fiscal techniques from impure political strategy. Fiscal policies are particularly the arguments arrayed for their defence can never be taken at face value as a safe guide for the use of similar policies in any other country, Canada for example.

166. Probably the classical case for deficit financing has less grounds for defence for use in Canada than in any other country that comes readily to mind. There are many reasons for this but one of the most important is the fact that such a large part of basic activity in Canada depends on demand for our products outside the country. Equally if not more important, is the fact that new capital investment decisions over this wide field depend mainly on foreign market prospects or indeed are directly made by businessmen abroad with foreign capital. Furthermore, a large part of secondary industry in Canada is geared to and fluctuates with activity and prosperity in our primary industries. They grew lustily and expanded mightily with and because of the thriving state of our primary industry in the prosperous post-war decade.

167. If this roughly is a fair picture of the state of affairs in Canada, it is not easy to assume that half, three-quarters or even $2 billion deficit in the Federal Budget would help much to bring more profits, employment or new investment into Canada through selling abroad more pulp, paper, wheat,

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iron ore, aluminum, nickle, asbestos, oil, copper, zinc, chemicals and so on. Nor would such a deficit be expected to stimulate much new investment generally in secondary industry. In other words, deficit financing would be pretty much money down the drain in Canada. Furthermore there is quite a large leak into imports which adds nothing to business and employment in Canada.

168. We already have a good volume of stabilizing welfare payments in Canada - family allowances, old age pensions, old age assistance, veterans' pensions, mothers' allowances and so on. Hospital plans in all the provinces are also a big help. Unemployment insurance pours out a constant stream of spending money and within the past decade, nearly a billion in excess of current contributions has been disbursed under this heading. Federal-Provincial agreements, splitting roughly on a 50-50 basis the cost of relief for all comers who need it, employables as well as unemployables, are in force in every province. On paper at least, there is no need for anybody in Canada to go hungry or lack shelter. All in all, we seem to have done a pretty respectable job of income maintenance as security against inability to work or inability to get work. In a very real sense, therefore, deficit financing cannot be said to be as necessary or even as effective as it otherwise might be in the absence of the measures just outlined.

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and dangers inherent in this type of budget management. Fiscal policy following the War was firmly directed toward stabilizing the economy. High taxes were well maintained for several years. Excess profits taxation had disappeared in both the U.K. and the U.S. before it was repealed in Canada. In the fiscal year 1946-47 expenditure was practically cut in half and a deficit of $2,123 million for the preceding year was converted into a surplus of $274 million. The next year the surplus was $676 million and in the year following was $595 million. In this period, business was booming. New investment was embarrassingly high and inflation was still a major problem. This kind of budgeting was eminently proper and no doubt helped toward slowing down price increases.

170. At the same time, parliamentary debates show very clearly the punishment a political government must expect to absorb in following this unpopular policy of "stealing money from the pockets of taxpayers" and "taxing away hundreds of millions more than they need to". Such a policy takes a great deal of political courage, an amount that could be afforded only by a strongly entrenched government. So much for surplus financing.

171. As for deficit financing, we have recently had occasion to learn that as fiscal policy, it can have limitations of a very real and compelling nature. The Budget this Spring came after a 4-year period with average annual "planned" deficits of over $500 million, the latest being $650 million. With the announcement

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of an estimated $745 million more for the current year, confidence of the investment world, particularly abroad, started coming apart at the seams. The immoderation of the following election campaign was no help. This trend towards higher deficits still in a year of really good business activity in Canada called into question the soundness of such a policy for a country which had obviously lost much of the impetus towards growth which it enjoyed in the full decade after the War. So with loss of confidence, we had a startling outflow of capital building up into a crisis, an austerity program and a start of the trek on the road back. Deficit financing as a respectable piece of fiscal doctrine for Canada will not soon recover its recent loss of stature.

172. The above described "policy" of deficit financing came about simply through continuous annual increases in the volume of expenditure without any positive steps to increase revenue to pay for it. It was as simple as that. The additional spending which resulted in continuous large deficits is more than accounted for by the increase in transfer payments to the provinces during this period. By the time of this year's Budget, the cumulative increase in payments to the provinces over the base year 1956-7 was about $2.6 billion while the cumulative deficit for the same period added up to $2.2 billion. That is to say, if the Government had merely carried on with the previous level of payments to the provinces, they could have had a balanced budget for the period with $400 million left over for debt reduction.

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173. Perhaps more often than by the method of increasing or decreasing, expenditure deficit or surplus financing is discussed in terms of tax cuts or tax increases. Involved here is a somewhat different set of important considerations which will now be briefly reviewed.

174. First of all, it is worthwhile in, say, a policy of cutting taxes to stimulate business, to look at the magnitude of the items in question. Today GNP is running around $39 billion. This is the overall size of the monster to be controlled. Annual capital investment is just about at the $9 billion mark. Retail sales are close to $18 billion. These are items of considerable magnitude.

175. Looking now at the weapons, we have to use for controlling this colossus, we find that the two taxes which mainly affect consumer spending, personal income tax and sales tax, add up to about $2.6 billion. Thus, if income tax and sales tax were both completely abolished and if people survived the shock and spent at once the whole of their tax savings, retail purchases would increase by just over 14%.

176. A more realistic assumption would be that personal income tax <u>alone</u> were to be cut by, say, 20%. This would free new purchasing power of just over $350 million. If all of this was spent, the boost to retail sales would be less than 2%. The leverage of the so-called control instruments is pitifully small. There will, of course, be some multiplier, but in periods of recession with inventories being down there is not

173. Perhaps more often than by the method of [illegible] [illegible] increases. Involved here is a somewhat different set of important considerations which will now be briefly considered.

174. First of all, it is worthwhile in, say, a policy of cutting taxes to stimulate business, to look at the magnitude of the items in question. Today [illegible] overall size of the monster to be controlled. Annual capital investment is just about at the $9 billion mark. Retail sales are close to $18 billion. These are items of considerable magnitude.

175. Looking now at the weapons, we have to use for controlling this colossus, we find that the two [illegible] income tax and sales tax, add up to about $2.5 billion. Thus, if income tax and sales tax were both completely abolished and if people survived the shock and spent at once the whole of their tax savings, retail purchases would increase by just over 14%.

176. A more realistic assumption would be that personal income tax alone were to be cut by, say, 20%. This would free new purchasing power of just over $350 million. If all of this was spent, the boost to retail [illegible] called control instruments is pitifully small. There will, of course, be some multiplier, but in periods of recession with inventories being down there is not

much to count on here. All in all, it would take a pretty drastic cut in taxes to make any very substantial or significant boost to retail sales. And this leads into the next point.

177. One must assume the theory of budgeting for control objectives to imply that fairly substantial increases or decreases in taxes at the appropriate times will be possible and necessary in order to bring significant desirable effects. The light-hearted assumption that programs of this kind and magnitude could, in practice, be easily carried out makes one shudder. Taxes these days are such an important element in family budgets that substantial increases or purely temporary decreases could scarcely be tolerated. Most of us have to plan our financial affairs pretty carefully. Mortgage commitments, life insurance, hospital and medical plans, instalments on the car, furniture and other durables, as a rule are arranged with considerable care and thought. These closely calculated family budgets would be thrown into utter chaos by abrupt changes in income tax. Furthermore, if personal taxes were cut sharply to encourage spending, the prudent person would put his tax savings aside and not spend them, knowing that before long the government will be back after it - and some more - to recoup its previous deficit. This, of course, would defeat the whole purpose of the tax cut. You just do not fool around in this fashion with high tax burdens. They are too serious. Twenty-five short years ago, federal taxes could be completely abolished or doubled

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over night without creating much change in anybody's way of life. This is not true any more.

178. What has just been said about the disruptive effects of abrupt tax changes applies, of course, mainly to personal income tax. Fiscal experts who love the idea of tax controls, however, look with special favour upon the use of sales and excise taxes as a means of draining off excess spending power. Here an entirely different set of troubles arises.

179. Manipulation of sales and excise taxes for control purposes may work fairly well, but only if the public is not expecting the government to use them. The public can practically ruin the effectiveness of the policy if they expect that the government is going to use them. During war-time we resorted to very high and numerous excise taxes on durable goods of various kinds. Many of these taxes were subsequently abolished, and all were at least reduced, in the post-war period. The Korean crisis immediately called for the same pattern of budget policy. Large increases in revenue were needed, and it was obviously necessary to divert productive resources from wide ranges of consumer durables for the support of defence requirements. What more natural, therefore, than that the government should resort to the re-imposition of the old excise tax program? The awkward fact was that the same idea (predicted in financial press) occurred to very large numbers of the buying public at the same time. The result was a wide-spread splurge of buying to get in ahead of the higher taxes expected in the 1951 budget.

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The budget fulfilled their expectations.

180. The natural outcome was, of course, a bad artificial slump following the budget in most lines of business concerned, not only because of the higher prices due to tax, but also because of the pre-budget anticipatory buying. Things would not have been too bad if defence orders had been in place the very next morning ready to take up the slack. It was probably nobody's fault that this was not the case. Timing was far from perfect. In fact, there was a quite unfortunate disorganization with considerable unemployment in certain directions at a time when the policy objective was to make the most efficient use of our productive resources.

181. Now let us follow the sequence of events still further. Owing to the severity of the tax effects of the 1951 budget, the public became convinced that the high tax program could not last because of the drastic dislocations resulting from it. That is to say, they thought it might be worthwhile to hold off buying in the expectation of certain taxes coming down or off completely in the next budget. Again they guessed right, making the dislocations and unemployment still worse. All in all, the use of excise taxes for control purposes during the Korean crisis was a rather unhappy experience even though, according to the book, the policy made excellent sense.

182. Another difficulty in the free use of sales and excise tax for control purposes lies in the inventory problem. When taxes are increased, dealers with stocks

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on hand rather promptly mark up their inventory and sell the next day at a price increased by the amount of the tax, even though no tax has been paid on the stocks on hand. Naturally, when taxes are lowered substantially, dealers take an inventory loss on tax-paid stocks on hand. This can be extremely disrupting and even disastrous for weaker firms. Inevitably, it causes a flood of representations to the government for relief. The seriousness of this inventory problem is shown by the events preceding the 1956 budget when, through fear of a lowering of the tax on automobiles, dealers from coast to coast refused shipments of cars from manufacturers. This threatened to cause slow-downs and unemployment in the manufacturing industry. The result was that the Minister of Finance had to announce ahead of time his intention to amend the law in the forthcoming budget to enable manufacturers to ship cars on consignment without incurring tax liability. To repeat, sudden changes in excise taxes can be very troublesome and disruptive. Experience seems to show that they are not a very happy choice as an instrument for control purposes.

183. The corporation income tax as a fiscal instrument does not appear to fit very well at all. It is pointless to take "purchasing power" away from corporations, as might be done from the public generally, with a view to cutting down demand for consumer goods, since corporations as a rule are not in the market to any extent for most consumer items. A sharp increase

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in corporation taxes might, of course, result in a smaller subsequent flow of dividends, but it is problematic how far consumer buying in Canada is supported by the spending of dividend income. It is possible, of course, that instead of reducing the dividend flow, higher corporate taxes might be passed on to the consumer in higher prices - the very thing the tax policy was intended to prevent.

184. It is sometimes suggested, however, that because a great deal of capital expenditure is financed out of retained corporate earnings, increased corporate taxes will have a restraining effect on the investment boom which, of course, is the main cause of the trouble in a period of inflation. Higher corporate taxes would mean that corporations would have less money to invest! This might make some sense as a policy if all corporations in the country were planning capital expenditure programs. This, however, is by no means the case. It is only in some directions that business concerns are expanding rapidly! It would be rather difficult to defend a policy which penalized every corporation in order to restrain some among them who were pressing forward too fast with expansion programs. Taking people's money away from them is a pretty serious business. An attempt to restrain capital investment by a gun shot blast of higher corporate taxes would be both clumsy and unfair.

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185. By the same token, a substantial lowering of corporate income tax in time of recession, welcome as it would be, could not be expected to induce much

new capital investment that otherwise would not be undertaken. Most businessmen would realize that the lower level of corporate taxes was a purely temporary phenomenon.

186. In attempting to assess the general effectiveness of tax policy as a method of control over the economy, it should be remembered that, in operating on the flow of purchasing power, tax policy is dealing merely with the results of inflation rather than with the causes of it. In this sense, tax policy can, in any case, be no more than a palliative and not a corrective of the fundamental problem. Taking a few hundreds of millions out of the spending stream scarcely touches at all the capital investment program which mainly creates the inflation problem.

187. One very awkward question faces the Minister of Finance in considering, in times of mildly rising prices, whether tax increases would be a wise move in support of a current tight money policy. The point is that none of his advisors may be able to tell him whether the price level increase is due to the pull of demand or the push of costs. One ventures to suggest that in 1956 when the consumer price index moved up by 3%, no one could have declared with certainty that it was the pull of demand that was causing it. The point is that unless the Minister of Finance had a pretty clear answer to this question, he would be at a complete loss as to whether a tax increase was the right thing or not. Furthermore, he would have to bear in mind that an income tax increase, for example,

resulting in a cut in take-home pay might, in a tight labour situation, be the basis for a new round of wage increases. If this did happen, his policy would be doubly defeated. That is, consumer demand would have been maintained and pressure from the cost structure would have brought about further price increases.

188. In such a situation just outlined where there were good grounds for expecting a price level increase, a restrictive bank policy would still make good sense regardless of which of the two factors - the pull of demand or the push of costs - was responsible; because some restraint on investment would operate not only to reduce tensions in the cost structure but also to slow down the flow of spendable incomes. The point being made here is that, while proper Bank Policy would be quite clear, the appropriate Tax Policy would not by any means be obvious. No Minister of Finance, with taxes already at a very high level, would relish the idea of raising them still higher in prosperous times just on the off-chance that it might possibly be the right thing to do.

189. There is an awful lot of pretty glib, vague and hollow talk and writing these days about what the government can and should do about so-called fiscal policy. In substance, it adds up to very little. Some years ago, when Geoffrey Crowther was retiring from Editorship of The Economist, he commented on the way governments today take upon themselves full responsibility for the state of the economy. He followed this by an expression of marvel at their

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presumption in view of the very puny little instruments they have at their disposal for backing up such claims. How much more should he marvel in viewing the situation in Canada!

Death Duties - Liquidity Problem

190. It was suggested that comment might be offered in this memorandum on the problem of meeting payments called for under death duties (presumably Federal estate tax and Provincial inheritance taxes). The question relates not to the absolute burden of the tax but the problem of arranging affairs to have sufficient liquid assets on hand to meet the payments within the required time. Possibly the main point of concern here is whether death duties in Canada have the effect of driving the family type of business into selling out - assets or shares - to public companies, particularly foreign public companies, in order to meet tax obligations. If this were so, it would be regarded as bad.

191. Perhaps as a general rule it can be said that insurance is the greatest source of liquidity in estates in Canada. The addiction of Canadians to insurance is something to marvel at. It is very useful, however, as a source of ready cash to meet death duties. Normally also, most estates will show fairly substantial holdings of marketable securities, bonds which have a ready market and stocks of a type and diversity that create no problem upon fairly quick realization.

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of course, in estates where the sole or main asset is in the form of "any income right, annuity, term of years or life or other similar estate". Here, the Federal law allows the tax applicable to such property to be spread over six years without interest. There are no such special provisions relating particularly to the situation where the main asset is a closely held family business - a going concern. There is, of course, a general provision in the law which gives the Minister discretion to postpone tax (with interest up to 5%) if he thinks the payment of it would cause "undue hardship or excessive sacrifice". It is not to be expected, however, that the necessity of selling out a family business at a fair price, where no preparation had been made by the deceased for meeting taxes on his death, would be regarded by the Minister as either hardship or sacrifice. It would probably be looked upon as just plain carelessness.

193. In approaching this question of liquidity in the case of closely held family businesses, there is no point in attempting to sidestep the fact that death duties are very high in Canada. Plenty of family businesses are worth $1-2 million. The tax (Federal and Provincial combined) on $1 million is just over $300,000 and on $2 million, it is nearly $800,000. From a $5 million estate, the tax would take close to half (54% rate applies on excess over $2 million). Quite clearly, the so-called liquidity problem can be quite acute for estates of this size made up mainly of a single asset, a family business.

194. For smaller businesses, the problem is not nearly so acute. For a business worth $160,000 ($60,000 exemption for married), the tax would be $19,000. The man might have insurance enough to cover this and his son would be able to take over the business unimpaired.

195. An estate made up of a $260,000 business would have to pay $44,000 tax. Ordinary life insurance might not be expected to take care of all of this, so a Trust Company might have to be called upon to arrange for a mortgage on some of the business property for, say, $25,000. This should be practicable with no particular problem of retaining family control. Mortgage interest will, of course, cut into the flow of income to his heirs but this has to be expected. At the same time, the interest charge against the business is a deduction in computing profits for corporate tax purposes.

196. At the $560,000 level the problem is getting a bit worse! Here, nearly $150,000 will have to be found. Insurance can no longer be counted on to take care of much of the tax unless the deceased had been foresighted enough to have over the years taken out an insurance-endowment policy specifically to meet death duties. Mortgages of higher amounts may have to be resorted to. Even so, it is reasonable to assume that up to the half million mark, there is no very good case for saying that the tax forces people to sell out a family business to a public company.

197. For a business of $750,000,the tax is just over $200,000, which calls for some pretty substantial financing. It would, however, still allow for a fairly reasonable equity-debt ratio for the business if a large portion of this tax liability were raised through mortgages. Interest, of course, would be cutting deeply into earnings of the heirs but if the business were fairly profitable with good prospects, there should be no real hardship. Still, not a very good case could be made for abatement in tax provisions.

198. It is for estates of $1 million up that the so-called liquidity problem becomes acute. It was mentioned above that for a $1 million estate, the tax is over $300,000, for $2 million, nearly $800,000 and for $5 million, about $2½ million. One cannot expect that tax money in these proportions will be available without careful planning a long time ahead. For the $5 million estate, it is too much to expect to have business as usual after the government has taken away half of it. Such a family business could only be continued as such if over a period of a good many years the proprietor had systematically built up a heavy position of liquid assets outside the business. He may have decided long ago that it was not worth it and accordingly, today finds himself among those who complain about taxation closing up his family business, having to sell out to pay tax! It is, of course, next to impossible to get a decent price for unlisted minority shares in a family-controlled business.

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199. This is a real problem and it is deplorable. Undoubtedly, the tax will have the effect of closing up family businesses. At the same time, one cannot readily see how this can be avoided in a socialistically-minded free enterprise democracy. If the public support the idea of taking into the public treasury one-half of a five million dollar estate there is not much one can do about it. It is just one of those things. Some discussion of this problem implies that the tax somehow favours a take-over by <u>foreigners</u>. There is nothing in this. It merely makes it sound worse.

200. Strictly speaking, the problem is not one of liquidity in the sense that it is in the case of an annuity where only a bit of time is needed in order to meet the payment. But six years in which to pay would not help a great deal in meeting the two-and-a-half million dollar tax on a five million dollar business. The point is that the tax is too large for devices of this sort to help much. They might help a little but probably not enough to forestall the almost inevitable result of selling out in the absence of long preparation.

201. Most estates under a million dollars do not really need a modification of tax law. It is hard, then, to imagine a Minister of Finance appealing to the House of Commons for some amelioration of the Estate Tax burden on, say, a five million dollar business. The public could not be expected to understand the problem and probably would not care a damn if they did. The government sponsoring this kind of relief

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would get merely horse-laughs from the Opposition.

202. The Income Tax law has gone quite a long and complicated way in attempting to make life tolerable for a privately-owned business. Usually, this kind of business grows and expands out of retained earnings. The result is that most of them have on hand large undistributed income. Very careful track is kept of this kind of retained earnings to prevent tax avoidance. Upon the winding up of such a company, the whole of this undistributed income on hand is deemed to be a dividend and with the piling-up of this much income in one year, the tax could be excruciating. During war time, the situation became simply fantastic. Tax rates at that time were so high that even with, say, a million dollar dividend, the taxpayer could not retain more than about $27,000. If, under these conditions, the proprietor of a family business died, the only way he could possibly meet his estate tax would be to sell the shares of his business and no one would be very anxious to buy the shares of such a company with this potential tax liability overhanging its surplus.

203. The solution finally worked out was to allow the company itself to pay a 15% tax on this undistributed income and thus create "tax paid" undistributed income which thereupon might be distributed to shareholders free of personal income tax. Any company may do this today on income accumulated up to 1949. From 1949 onward, they may qualify one half their earnings for this treatment by paying out the other half.

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204. Today, the corporate tax on income up to $35,000 is only 21%, with a 20% dividend tax credit. This is fairly lenient tax treatment. The proprietor of the business can then gradually create tax paid undistributed income on hand and thus put himself in a position to borrow money on mortgage from his business and provide liquid funds for meeting estate tax. It is suggested here that the way has been paved as far as is <u>reasonably possible</u> to enable family control of businesses in Canada to be maintained.

<u>Tax Status for Credit Unions</u>

205. Doubtless the Commission will have received argument from various classes of financial companies that the income tax exemption for Credit Unions is terrible and should be withdrawn. Doubtless also, Credit Unions will maintain that it is just right and should be retained. It has been suggested that this memo might comment on the situation pro and con.

206. Almost invariably, emotions promptly creep - or more often barge - into any discussion about co-operatives. The leaders of the movement are evangelistic types who are inclined to look hurt or sorrowful at the very idea of any interference in their good works by the State. Private business, of course, resents their very existence and usually have an exaggerated fear of their potential. A bit of a cold war is carried on in annual Briefs to the government. Mostly this is pretty harmless sniping at each other. There are some recent signs that the question may hot up again.

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207. While the Co-Operative Union of Canada does not regard the Credit Unions and Caisses Populaire as directly under their wing possibly they can be expected, on general principles, to use some of their <u>not inconsiderable</u> political influence to preserve the tax status quo for the Credit Unions. They operate under the same general philosophy.

208. If the defence of the tax exemption for Credit Unions is to rest on "co-operative principles", it would be well to have a look at the general tax law which covers co-operatives and see whether it is appropriate for the special field of Credit Unions.

209. All in all, we have in Canada, pretty sensible tax laws for co-operatives. Actually, the main provision which alleviates their tax position is not limited to co-operatives at all but applies to any company. Any company which holds forth the prospect of patronage dividends to its customers may deduct the amounts disbursed in this way in computing its income for tax purposes. It is sensible in a free country that any company should be allowed to hand back profits to its customers, i.e., giving them a year-end discount on their purchases from the corporation or an additional payment to its customers on its purchases from them. It may choose to do this instead of passing out dividends to shareholders as a return on their capital. This is the form of doing business. There is no special privilege in this tax provision. It merely recognizes one of the ordinary practices in doing business. Profit-sharing plans are

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not uncommon in private industry.

210. There is a rather curious provision limiting the deduction of patronage dividends. The deduction may not reduce taxable income below 3% of capital employed. The theory was that capital has its own earning power independent of the form of business and this piece of earnings should not and could not logically be paid out to customers as a reward for patronage. This obviously is a bit far-fetched but there it stands. It is hard to see why a company should not be allowed to dish out whatever it likes as a bonus for patronage. The source of its funds should not matter.

211. Actually, to qualify for deduction, patronage dividends do not have to be disbursed in cash. They can be declared and credited to members. This in law constitutes payment. A company by-law may then require the members to leave the amount on loan with the company for a period of years. In this way, through the revolving fund technique, the co-op gets its working capital pretty cheaply. No ordinary business concern, of course, could do this but in defence of the practice, it might be said that it is simply one of the inherent by-products in the co-op method of doing business and cannot legitimately be complained about by private business as special tax privilege. If a co-op wants to impose forced savings interest free or at a low rate on their members, they surely have the right to do so. No one else should complain.

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212. Co-ops upon formation are given a three year exemption. This is special privilege otherwise reserved exclusively in the tax law for mining companies. There is no good case for it and it spoils the purity of an otherwise defesible tax position for co-operatives (except for the 3% rule).

213. Perhaps we might start the discussion of the Credit Union tax position by saying that on general principles all outright exemptions from tax are bad. The second point which might be made is that as a general rule in tax legislation,a benefit once uttered can never be recalled. However, it is not as if Credit Unions had once been taxable and were then overtly granted a benefit. It is merely that when co-ops generally were deprived of their tax-exempt status following the McDougall Commission Report, the Credit Unions were left outside. The Report recommended that they be left alone! The Minister of Finance accepted this recommendation. At the time the movement was mainly centered in rural Quebec and it is not too surprising therefore, that the Minister went along with the recommendation. Of total assets in 1943 of $69 million for Canada as a whole, about $61 million (88%) was on the books of Caisses Populaire in Quebec.

214. In the meantime, Credit Unions have had a phenominal growth. They are now big business. Assets have moved up for $69 million in 1943 to $1,299 million in 1960 with only 51% of assets in Quebec. They now have more than 2.6 million members.

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214. In the meantime, Credit Unions have had a phenomenal growth. They are now big business. Assets have moved up for $69 million in 1943 to $1,299 million in 1960 with only 53% of assets in Quebec. They now have more than 2.6 million members.

215. The arguments in the McDougall Report for continued tax exempt status for Credit Unions were based mainly on the position of small rural Unions in Quebec. Today these arguments are not impressive at all for organizations with assets of $1.3 billion, membership of 2.6 million with 4,667 offices from coast to coast, less than 35% of which are classified as rural.

216. It is all right and noble to encourage "people in poor circumstances to develop habits of thrift" but let us not try to visualize 2.6 million Canadians as in poor circumstances. And probably through the good offices of Credit Unions as many are being encouraged to borrow as to save, which is all right too.

217. "We are satisfied that credit unions perform a highly useful function in assisting people who are unable to take effective advantage of savings and loan facilities provided by other lending institutions." Of course, they perform a useful function but it would be going a bit far to suggest in 1960 that the 2.6 million people they are assisting "are unable to take effective advantage of savings and loan facilities provided by other lending institutions"? Not many people in the country are more than half an hour by car away from a branch of a chartered bank. Few city and town dwellers are more than a few minutes walk away from a small loan company office or a branch bank. Trust companies fill in in the large towns and cities. Over the radio, by T.V., and in daily and

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weekly newspapers, these companies plead for more customers. Lack of facilities for borrowing or saving is scarcely a problem these days. The country is stiff with them.

218. Arguments for exemption, (b) (c), in the McDougall Report are these:-

> (b) The bond of association, occupation or other community interest on which the membership of credit unions is based tends to minimize the element of risk which has to be considered by another type of lending institution when considering an application for a loan from an individual with little or no collateral security;
>
> (c) Accordingly, it provides a service for those who are either not provided with credit services from other lending institutions at all, or only at much higher rates because of the risks involved.

219. There is no doubt about it Credit Unions can lend money more cheaply - with less risk - to their fellow members than can a small loan company to its customers. A small loan company has to start cold when a customer walks in off the street and wants money. The total cost of making small loans is by no means represented by the cost of securing money to re-lend. It is a very expensive, time consuming and tricky business to find out whether the customer will be both <u>willing</u> and <u>able</u> to pay back the money he has borrowed. In a Credit Union, the Credit

Committee, if they are any good, will know these things about the applicant and can almost automatically - and without expense - give a yes or no to an application for a loan. In Ontario the maximum which may be charged by a Credit Union is 1% per month on the unpaid balance. A tough-minded Parliament allows small loan companies to charge 2% per month on loans up to $300 and they do, in fact, charge ceiling rates on everything up to $1,500. Credit Unions frequently make instalment loans at 3/4% or 1/2% per month on unpaid balances. For term loans, the rates may vary from 6% to 9% per annum. On this kind of business at these rates they apparently make profits and pay patronage dividends.

220, A few conclusions may now be drawn:-

(a) Credit Unions on a rate basis are not vulnerable to competition from private financial institutions.

(b) They do not need tax exemption in order to fulfill their mission of self-help.

(c) Where they have built up the reserve required under provincial law, they are not supposed to be in business to make a profit anyway, so why should they need exemption from a tax on profits?

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221. "We are also satisfied that credit unions are not displacing any other type of business enterprise, except to provide an alternative source of loans in a field where individual money lenders or lending institutions do not provide similar credit

facilities at comparable net rates". This statement seems to imply that the volume of business of private institutions in the small loan field is not really injured in any way by the activities of Credit Unions. Whatever might be said of the situation in 1943 when personal loans by Credit Unions probably did not exceed $10 million would scarcely be true in 1960 when personal loans made by Credit Unions were about $425 million. This compares with only $392 million of small loan balances outstanding on the books of all small loan companies and licensed money lenders in the same year. These figures suggest that in the small loan business co-operatives have cut into private business on a grand scale. It is not suggested that all of the $425 million small loan business of the Credit Unions would otherwise have gone to private loan companies and banks but it is safe to assume that quite a large part of it would have. It would not be surprising therefore, if small loan companies and the banks were to complain pretty bitterly about the favoured position of Credit Unions through tax exemption. At the same time, it almost goes without saying that the private enterprise fellow will vastly over-rate the importance of the tax exemption in their competitive position vis-à-vis Credit Unions.

222. From the above, it does seem that there is a clear case for recommending the repeal of Section 62 (1) (k) of the Income Tax Act which exempts Credit Unions from tax. They would then fall to be taxed as ordinary companies and would be allowed to deduct

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patronage dividends if they held out the prospect of them to their members - which most of them do. The limitation (3% of capital employed) on the deduction would likewise apply. It appears also that the three year initial exemption would likewise apply to them since they are incorporated under special provincial co-operative legislation. All of this means simply that they would be treated for tax purposes the same as any other co-operative.

223. This sounds all very simple and straightforward but the Commission should know that it might mean that Credit Unions (at least in Ontario) would have to revise their systems pretty drastically to avoid paying quite a bit of tax. On the other hand, it should not (in substance at least), cause much trouble in Quebec.

224. The point is that in Ontario, most of the funds (savings) put in Credit Unions is through the purchase of $5 shares ($140.7 million) and only a relatively small amount is put in in the form of savings deposits, ($10.7 million). In Quebec, only $60 million was put in as share capital and $596 million as savings deposits. The first point is that "the amount paid pursuant to a legal obligation to pay interest" is deductible in computing profits for tax purposes while the amount paid out as dividends is, of course, not deductible.

225. As a matter of fact, it seems almost certain that in Ontario, the so-called interest paid on savings deposits would not qualify as a deduction since

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226. This is a pretty confused and slap-happy situation. Apparently, the idea of taking members' savings in the name of share capital rather than savings deposits is to give the member the feeling that the company is his - he owns a piece of it - and that his Union is not merely an independent corporation that owes him the money he has deposited with it. One other reason mentioned is that sixty days' notice may be required for redemption of shares while only thirty days may be required for withdrawing deposits - (this sounds a bit phony).

227. The writer has not taken the time nor spent the money to get a legal opinion on the status of so-called interest payments on deposits in other provinces. He has been told that the legal distinction between the position of shareholder and depositor is pretty clearly established in Quebec. In all provinces, the rule is one member, one vote, regardless of share ownership.

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228. If Credit Unions do not wish to bind themselves to much of a fixed contractual rate of interest for a year, it would seem quite simple for it to call the voluntary interest in excess of say, 1%, a patronage dividend, that is, a year-end payment to the customer (depositor) for having left savings with the company. It is already common practice to pay patronage dividends to <u>borrower</u> customers, a 10% to 15% refund of the interest he has paid to the Union during the year. The Unions' customers are both borrowers and lenders. There is no obvious reason why they should not both get patronage dividends, with the lenders getting the same amount (less a fraction), which they now get in the name of voluntary interest. It is clear, however, that Credit Unions would have to pay tax on the profits now disbursed as dividends on share capital (Ontario, for example) unless they change the form of the paper they hand out from a share certificate to a deposit certificate with a low fixed rate of interest and with the prospect of a patronage dividend taking the place of an ordinary dividend on share capital.

229. In view of the 20% tax credit for dividends received from taxable corporations, there should not be really much substance to any opposition by Credit Unions to the removal of their tax exemption. The removal of the exemption would make Credit Unions taxable corporations. Probably after deduction of interest and patronage dividends few Credit Unions will have taxable income in excess of $35,000. This means that as a rule their federal and provincial

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corporate tax combined will not usually exceed 21% or 22%. Nearly all shareholders who pay income tax - and it is fair to assume that most of them do - will be able to offset against their personal income tax the tax paid upstairs by the corporation on dividends distributed to them. This may undermine to some extent the opposition to a change-over. However, particularly in the rural Credit Unions and Caisses Populaires, there will be some who, because of large personal exemptions will pay no income tax. They will receive no offset and accordingly, will have some remaining basis for complaint against the change-over.

230. Credit Unions which are not old enough to have built up the reserve required by provincial law (10% of share capital and deposits) would always be taxable on the amounts transferred each year to the Guarantee Fund. 20% of yearly net profits have to be set aside until the fund reaches the 10%. A 21% tax on 20% of net earnings is not a very heavy tax burden and would not slow down very much the growth of reserves but, of course, it would be complained of as hitting the weakest of the lot. This, of course, is a bad feature but all private business has to build reserves out of tax paid money so let us not weep over the situation. It happens to everybody now except Credit Unions. It would, of course, be wrong in principle to allow in <u>federal</u> legislation a deduction for amounts transferred to reserve under a requirement of <u>provincial</u> law.

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231. SUMMARY

(a) The arguments of the McDougall Report for Credit Union exemption no longer have any significant validity.

(b) The present exemption Section 62 (1) (k) of the Income Tax Act should be repealed.

(c) In the absence of the present exemption Credit Unions would fail to be taxed in the same manner as any other co-operative.

(d) Allowing patronage dividends as a deduction is eminently sensible in law taxing the profits of corporations. The 3% limiting provision is an illogical penalty. The three year exemption is undeserved privilege.

(e) There is a very awkward situation, particularly in Ontario, and possibly in all provinces regarding the deductibility of interest payments since generally they seem to be entirely voluntary without legal obligation.

(f) In Ontario particularly and possibly in most provinces except Quebec Credit Unions may find it desirable from the tax point of view to convert shares into deposit certificates.

(g) Credit Unions may find it expedient to pay patronage dividends to lenders as well as to borrowers if they do not wish

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(g) [illegible] to pay patronage dividends to lenders as well as to borrowers if they do not wish

to contract for more than a small amount of annual interest on deposits.

(h) The 20% dividend tax credit will recoup most members for the tax paid upstairs by the Union.

(i) Amounts still to be transferred to Guarantee Fund would bear tax in future but there is nothing wrong with this. All private companies do too.

(j) Making Credit Unions taxable will not slow down their growth or hurt their existence appreciably. This is another way of saying that a 21% tax on a small profit margin will make little difference in the gross lending rate or the gross rate paid on deposits. The competitive advantage through tax exemption alone reflected in the rate structure could be put in your eye. Removal of the exemption, however, would wipe out the strong feeling of resentment that exists today because of the privileged position of Credit Unions in tax law. It should be removed.

A. K. Eaton

SUBMISSION TO

THE ROYAL COMMISSION ON BANKING AND FINANCE

BY

THE EXECUTIVE COUNCIL

OF

THE CANADIAN CHAMBER OF COMMERCE

300 ST. SACRAMENT STREET

MONTREAL, QUEBEC

September 4, 1962.

The Honourable Dana H. Porter,
Chairman, Royal Commission on Banking and Finance,
Ottawa, Ont.

Dear Mr. Chairman:

I. INTRODUCTION

The Executive Council of The Canadian Chamber of Commerce submits its views on some aspects of Banking and Finance in Canada. The Chamber agrees fully that the time is appropriate for a careful and intensive review of Canada's financial structure. It hopes that the Commission will be able to recommend changes of lasting benefit to the Canadian economy.

The Canadian Chamber of Commerce is the national voluntary federation of over 850 community Boards of Trade and Chambers of Commerce (the terms are synonymous) throughout Canada.

These community Boards and Chambers are established to promote the civic, commercial, industrial and agricultural progress of the communities and districts in which they operate and to promote good government at all levels. 75% of these community Boards and Chambers of Commerce serve communities of less than 5,000 population. Included among the Canadian Chamber's objectives are the development and presentation of an informed public opinion and the securing thereby of effective action by the national legislature upon questions relating to the economic and public welfare. The Chamber aims at supporting and developing the Canadian system of representative government and the preservation and further improvement of Canada's economic system based upon private

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initiative and individual enterprise. It also is concerned with the initiation and promotion of policies designed to further the more effective use of the nation's resources of manpower, raw materials, technological knowledge, production facilities and money.

This brief is based upon the democratically evolved principles and policies of the Canadian Chamber and is submitted by the Executive Council, which is appointed by the National Board of Directors, the governing body of the Chamber, to carry on the ordinary business of the Chamber during the interim between meetings of the Board.

II. PRINCIPLES

The broad principles of the Chamber regarding the functioning of Canada's economic system are well known, having been outlined in detail in its Policy Declaration on Freedom of Enterprise, adopted at the annual meeting of the Chamber in October 1961, and need only briefly be referred to here. Attached as an Appendix, is a copy of above mentioned Policy Declaration.

The Chamber regards the maintenance of personal freedom as being of paramount importance, and feels that wide latitude of consumer's choice, liberty of the worker in choosing his employment, and independence of the enterprising spirit are integral parts of personal freedoms. In addition, the Chamber believes that in order to make these freedoms meaningful in all cases, adequate measures must be

initiative and individual enterprise. It also is concerned with the initiation and promotion of policies designed to further the more effective use of the nation's resources of manpower, raw materials, technological knowledge, production facilities and money.

This brief is based upon the democratically evolved principles and policies of the Canadian Chamber and is submitted by the Executive Council, which is appointed by the National Board of Directors, the governing body of the Chamber, to carry on the ordinary business of the Chamber during the interim between meetings of the Board.

II. PRINCIPLES

The broad principles of the Chamber regarding the functioning of Canada's economic system are well known, having been outlined in detail in its Policy Declaration on Freedom of Enterprise, adopted at the annual meeting of the Chamber in October 1951, and need only briefly be referred to here. Attached as an Appendix, is a copy of above mentioned Policy Declaration.

The Chamber regards the maintenance of personal freedom as being of paramount importance, and feels that wide latitude of consumer's choice, liberty of the worker in choosing his employment, and independence of the enterprising spirit are integral parts of personal freedoms. In addition, the Chamber believes that in order to make these freedoms meaningful in all cases, adequate measures must be

provided to protect the material standard of living in the case of individuals who experience loss of income due to inadvertent misfortune through unemployment, accident or sickness.

The Chamber believes that this kind of individual well-being will best be achieved within an economic framework where competitive enterprise is permitted to make its maximum contribution, and where government policies are designed to facilitate this contribution.

The Chamber believes that these broad principles apply as fully to the kind of financial system or capital market that Canada should strive to build and preserve as they do to the kind of economy in general that Canada should hope to enjoy. Indeed, the Chamber is convinced that free play in the allocation of the nation's capital -- a primary function of the capital market -- is a prerequisite for freedom in business enterprise; for the structure of the economy will finally be decided by the way savings are put to use.

More specifically, the Executive Council believes that the economy will best be served by a capital market that is free, competitive and viable. It does not believe that the capital market is functioning perfectly now in every respect; nor, to be realistic, does it believe that a time will come when it will function perfectly in every respect. What it does believe is that the market functions immeasurably better than any system based on

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governmental control of the way the nation's savings are put to work. The Executive Council believes that the present deficiencies in the capital market can be remedied so as to make it function even more efficiently than it does now.

The role of government should be one of encouraging the system to function more smoothly.

III. SUMMARY OF RECOMMENDATIONS

There is summarized below the recommendations which have been made in this Submission:

1. THAT the role of government be to encourage the private competitive economic system to function more smoothly.
2. THAT co-ordination be developed among various official fiscal, monetary, debt, and exchange policies comprising one overall economic policy for which the government is responsible.
3. THAT the Bank of Canada Act be amended so as to give the government the authority to issue broad directives to the Bank of Canada on overall monetary policy.
4. THAT there be established an advisory body of financial people on whom the government might call for advice on the technical aspects and effects of the government's operation in the financial market.
5. THAT consideration be given to the Bank of Canada appointing to its staff, on a short

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2. THAT co-ordination be developed among various official fiscal, monetary, debt, and [illegible] economic policy for which the government is responsible.

3. THAT the Bank of Canada Act be amended so as to give the government the authority to issue broad directives to the Bank of Canada on overall monetary policy.

4. THAT there be established an advisory body of financial people on whom the government might call for advice on the technical aspects and effects of the government's operation in the financial market.

5. THAT consideration be given to the Bank of Canada appointing to its staff, on a short

term basis, a senior executive who has enjoyed an extended period of experience in the financial business, outside the Bank of Canada.

6. THAT the government, as well as the central bank, recruit personnel experienced in the technical operations of the capital market.

7. THAT an effort be made by the Bank of Canada to inform the public more clearly about the purposes and capabilities of monetary policy.

8. THAT a fixed central bank rate is desirable and should be retained.

9. THAT the membership of the Board of Directors of the Bank of Canada be changed so as to include individuals of long experience in the operation of the financial system. To this end, it is suggested that the composition of the Board should emphasize competence in financial and economic matters.

10. THAT anti-cyclical fiscal policy be followed which can quickly be reversed, e.g., tax adjustments rather than changes in government expenditures.

11. THAT measures to provide a level of material security to the unemployed are a necessary part of anti-cyclical economic policy.

12. THAT a review be made of the government's financial institutions to determine what areas of government operations are adequately

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13. THAT government financial institutions should not operate on subsidies but be self-sustaining, and that these institutions provide sufficient material in their annual and other reports to enable the observer to appraise adequately their operations.

14. THAT tax exemption for credit unions be removed.

15. THAT government explore with the institutions of the capital market the filling of some gaps in the capital market by new private corporations.

16. THAT there should be more frequent changes in the prime chartered bank rate and that the ceiling on interest rates of bank loans be removed.

17. THAT recognizing the necessity of raising risk capital, the commissioners consider measures to eliminate abuses and unethical methods in the sale of very risky and highly speculative stocks.

IV. ECONOMIC STABILIZATION POLICIES OF GOVERNMENT

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The financial system is directly influenced by the government's monetary, fiscal, debt and exchange rate policies. Co-ordination between those

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policies is essential. The nation's ability to achieve the over-all objectives of high level employment, satisfactory increases in the standard of living, and reasonable stability of prices will be enhanced if such co-ordination exists; otherwise it will be jeopardized. Lack of constant co-operation and co-ordination may lead to policies which create the impression abroad that Canada is unable to manage its own affairs in a competent manner.

To those who would argue that Canada need not concern itself with the views of other nations, the Executive Council would reply that our trading and investment interests demand that Canada's counsel and credit in international financial and economic circles be held in respect.

It is equally important that Canada should do nothing which discourages foreign investment, since it is unlikely we can, for some time, fully finance the capital development which will be necessary to secure our national objectives of employment and productivity.

Co-ordination between the various official policies is also necessary from a technical point of view. It has been obvious over the last several years that the success of the government's fiscal policy must ultimately depend on the ability of government to finance its deficit through the bond market; and its ability to sell those bonds may depend heavily on the kind of monetary policy being pursued by the central bank, as well as its own fiscal policies. On the other hand, fiscal and monetary policies being pursued

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will influence the rate of exchange on the Canadian dollar. Accordingly, the Executive Council believes that policy co-ordination is essential, and that separation is futile.

For these reasons the Executive Council believes that the various afore-mentioned policies should really be regarded as a part of one overall economic policy and for which the government is unmistakably responsible.

This matter should be clarified, and the Executive Council recommends that the Bank of Canada Act be amended so as to give the government of the day the authority to issue broad directives to the Bank of Canada on overall monetary policy when the views of the government are contrary to the Bank's policy.

The Executive Council feels that the position and prestige of the Bank of Canada must not be undermined; but rather it will be enhanced if the public is assured that the Bank at all times enjoys the confidence of the elected government.

2. Relationships between the Financial System and the Government's Financial Policies

Monetary policy is implemented through the machinery of the capital market; it requires the Bank of Canada to buy and sell securities -- to operate in the market. Government fiscal policy also involves frequent official contact with and operations in the markets; for example, when there is a cash deficit, bonds have to be sold. Similarly, the government's exchange rate policy requires frequent official action

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in the market.

The point to be emphasized is that government has become a major force in the day-to-day operation of the financial markets. It would appear however that government at times has been insufficiently aware of the effects of its action on the capital market. Therefore, the Executive Council believes that it would be useful for there to be established an advisory body of financial people on whom the government might call for advice on the technical aspects and effects of the government's operation in the market. The Executive Council feels that consideration should also be given to the Bank of Canada appointing to its staff, on a short term basis, a senior executive who has enjoyed an extended period of experience in the financial business outside of the Bank of Canada.

In addition, in those key areas of the machinery of official policy where contact with the capital market is frequent and important, the Executive Council would recommend that the government, as well as the central bank, recruit personnel experienced in the technical operations of the capital market. The Executive Council feels that economic policy will be implemented more smoothly and will create fewer distortions in the functioning of the capital market if this were done.

3. Stabilization Policies

(a) Monetary Policy

The Executive Council believes that maximum use should be made of the monetary mechanism,

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There is sometimes a tendency on the part of the public to expect too much from monetary policy. Disappointment may follow because the judgment of the central bank's management may have been fallible, or because public expectations were unrealistic. The Executive Council recommends that an effort be made by the Bank of Canada to inform the public more clearly about the purposes and capabilities of monetary policy. This would have the advantage of enabling the financial press to explain policy to a large section of the general public.

As to the effectiveness of monetary policy, the Executive Council feels that it will be enhanced by the return to a fixed Central Bank Rate because it may lead to greater flexibility in "institutional" interest rates such as the chartered bank loan and savings deposit rates. The Executive Council has preferred a fixed Central Bank Rate because it gives businessmen a clearer impression than formerly was possible, of the basic trend of central bank policy.

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There has been a natural tendency to read the Bank of Canada's weekly statement for signs of a change in policy, with the result that purely transitory developments in that statement sometimes have been interpreted as basic policy changes. Changes in a fixed Bank Rate will encourage public discussion of monetary policy and of the problems of economic stabilization. In addition, it appears likely that in time the somewhat rigid borrowing and lending rates of banks and other institutions will begin to move with the changes in the fixed Bank Rate and so will become somewhat less rigid -- a development which would enhance the effectiveness of monetary policy for economic stabilization. The effectiveness of monetary policy would be enhanced if it were generally recognized that "tight" money is intended to "hurt", and if great care were taken to ensure that it did not cause unjustifiable hardships in particular sectors of the economy.

The Executive Council believes that the central bank's relations with and operations in the financial market, as well as the nature of its policy would be improved if it had as advisers individuals with long experience in the operation of the financial system. It recommends therefore that the membership of the Board of Directors of the Bank of Canada be changed so as to permit this to occur. The composition of the Board should emphasize competence in financial and economic matters.

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interpreted as implying that the Executive Council places complete reliance on monetary policy, for it does not do so. It is essential that, due to the limitations of monetary policy, appropriate fiscal policies, as well as suitable debt management and exchange rate policies be followed.

The Executive Council feels that a clear distinction should be drawn between fiscal policy designed to deal with the business cycle, and fiscal policy designed to achieve longer run national objectives. Any anti-cyclical fiscal policy adopted should be one which can quickly be reversed. The Executive Council favours tax adjustments rather than changes in government spending - particularly government spending which cannot be reversed quickly and which does not add to useful social capital.

One aspect of desirable fiscal policy deserves special consideration: this is the effect it has on business enterprise. The Executive Council feels that government fiscal policy should be designed so that it will provide an incentive for economic growth in the private sector during periods of slack economic conditions and for restraint during periods of inflation. The recent budgetary changes relating to the acceleration of capital cost allowances, tax concessions relating to sales increases, and the encouragement of research ezpenditures are examples of such fiscal measures.

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It is regarded as inevitable that even with the most proficient use of monetary and fiscal policies, there will be times when the economy is not working at full capacity. Canada's position in international trade alone suggests that this will be so. Therefore, there will remain the problem of meeting the material needs of people who periodically are unemployed. Those needs, based on our social consciousness, can properly be regarded as the costs of retaining the type of economy we have, and meeting them can properly be regarded as spreading in an equitable fashion the costs of retaining that system.

For this reason at least the Executive Council regards measures designed to provide a level of material security to the unemployed as being a necessary part of anti-cyclical economic policy.

V. GOVERNMENT IN THE BUSINESS OF FINANCE

We earlier stated the view that when government intervenes in the functioning of the financial system, it should do so with the objective of improving the functioning of that system and filling gaps in it that need to be filled and are not being filled by the private sector. It is the latter which should be the criterion when deciding whether government should or should not itself establish financial

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institutions such as the Industrial Development Bank or Central Mortgage and Housing Corporation; or whether or not it should introduce special arrangements such as guaranteed loans to home owners, farmers, and small businessmen.

It is not the intention of the Executive Council to review the operations of the government's financial institutions in order to indicate which ones are and which are not following that criterion. The Chamber does, however, recommend that such a review be made of the government's financial institutions and that steps be taken to eliminate government operations in areas which are adequately served by private business. We wish to make several additional points.

First, government financial institutions should not as a general rule operate indefinitely on subsidies; they should be self-sustaining. All costs, including depreciation, taxes and a competitive rate on funds they borrow, should be taken into account. The need to fill gaps is not synonymous, in most cases, with the need to provide subsidies. This would ensure that if government institutions do in fact impinge on the areas of the capital market already being served by private institutions they will at least do so in a fair and truly competitive manner.

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Third, the Executive believes that gaps in the capital market should in most cases be filled by new private corporations. For example, the Chamber is encouraged by the formation of the Export Finance Corporation of Canada Limited, a private company whose principal purpose is to provide medium term financing for exports which are insured by the Government of Canada's Export Credit Insurance Corporation. Other more recent examples are the formation of RoyNat Corporation and The Canadian Enterprise Development Corporation Ltd., organized by groups of large lending institutions.

Finally, consistent with its opposition to subsidies for government financial enterprises, the Executive Council opposes concessions to other activities such as the exemption of credit unions from corporations income tax. We see no economic justification for such an exemption, particularly now that credit unions have become big business.

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VI. DEFICIENCIES OF THE CAPITAL MARKET

The Executive Council does not pretend to be able to outline all or even most of the areas where improvements in the capital market may be made. It will refer only to a few which have come to the attention of some of its members. But first it should be made clear that the Executive Council deplores abuses and unethical methods in the sale of very risky and highly speculative stocks; it deplores the fact that the impression which the public has of the financial system is too frequently based on isolated instances of such abuses; and it urges the Commissioners to consider measures which will eliminate them. For a capital market to remain free it must retain the confidence and support of the general public.

The Executive Council feels that the financial system would be improved if competition within the banking system were improved. While there is competition between banks on services provided, it does not extend to the prime loan rate or the savings deposit rate. Increased flexibility in these rates is desirable.

The 6% ceiling on chartered bank loans is an anomaly in a free market and it is recommended that the ceiling be removed. It should be remembered that this might help some borrowers who are not now able to obtain loans, and would enable the banks to pay a higher rate on savings deposits. Also, the 6% ceiling should be really viewed as being "paid for" not by the

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banks but by the saver who now obtains a low rate of interest on his savings account.

Further flexibility could be achieved by encouraging the banks to become more competitive in their rate setting. The Executive Council does not believe that such a policy would produce different rates between banks -- indeed in a highly competitive situation one would expect them to be the same -- but what it might produce is different levels of rates in general and economically more appropriate timing in the change of rates. Changes in these rates should more closely coincide with changes in economic conditions and in the capital market than has been the case in the past. Both the business community and monetary policy would benefit from such increased flexibility.

The Executive Council recommends that the chartered banks' freedom in deciding to whom they should make loans should not be compromised. At the same time it feels that periods of tight money restrict small businesses more than large businesses because the small businessman frequently has only one outside source of funds -- his banker. It, therefore, further recommends that the government take steps to ensure that it has current information on the problem and, if necessary, introduce measures which will place small businesses with good credit on an equal footing with large business during periods of credit restriction.

All of which is respectfully submitted.

D.L. Morrell General Manager	F.W. Bradshaw Chairman, Executive Council

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Appendix

FREEDOM OF ENTERPRISE

Canada's Economic System

The Canadian Chamber of Commerce believes in and supports the economic system of competitive enterprise based on individual freedom of choice and personal initiative and responsibility.

The Canadian Chamber of Commerce believes that one of the basic aims of public policy should be the maintenance of personal freedom. In this atmosphere the consumer is free to make his own choice as to how, when or where he will spend his income. These individual choices collectively provide the great stimulating and controlling force governing production. For this force to operate effectively, suppliers of goods and services must be free to compete for these choices, satisfying old ones more economically and searching out new ones promptly. In this competitive atmosphere, only the efficient suppliers of goods and services can prosper. Suppliers who remain inefficient or who continue to produce things no longer wanted will not survive. Through such competition, changes take place and efficiency is increased to the benefit of the consumer. Hence come the phrases "Freedom of Enterprise" and "The System of Competitive Enterprise".

Canada can be great and prosperous only if all individuals have the incentive of adequate reward for risk, energy, initiative and enterprise, along with the right to enjoy the fruits thereof.

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Canada can be great and prosperous only if all individuals have the incentive of adequate reward for risk, energy, initiative and enterprise, along with the right to enjoy the fruits thereof.

The Chamber affirms that the core of its policy is to support the enterprise system. It believes that within the freedom concept, limitations on the freedom of the individual are justified in the interests of law and order. However, the unwarranted and arbitrary exercise of power by governments, often influenced by collectivist theories, destroys initiative and curtails the dynamic qualities which are essential to the productive operation of private enterprise.

The Chamber recognizes economic education as the most potent instrument for the extension and development of the Canadian enterprise system. In this regard, the Chamber is committed to do all in its power to help with the enlightenment of the individual so that he can develop better understanding and act on his own authority and responsibility.

The Chamber recognizes the responsibility of society to help those individuals incapable of providing for themselves, but does not believe that it is the business of the State to provide those services which the individual can supply for himself. Social security must not become an end in itself. Canadians must beware of looking to the State to provide security to the extent that the individual loses incentive to provide for himself.

If ever business, or the people in general, come to believe that they can turn to government in every difficulty, the springs of initiative and self-reliance will run dry. The Chamber puts its faith in the responsibility and the resourcefulness of

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individuals operating under the competitive enterprise system, believing that these factors will ensure the highest possible standard of living for the whole Canadian people.

RECOMMENDATIONS:

1. that members of the Chamber promote a greater appreciation of the economic system of competitive enterprise.
2. that member Boards and Chambers establish active Public Affairs Committees with a view to developing at the local level programs of action with respect to provincial and national problems.

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Royal Commission on Banking and Finance

CANADIAN LABOUR CONGRESS

Hearings held at

OTTAWA

Vol. 52

Date. 24 OCT 1962

Official Reporters
F.J. Nethercut and R.J. Young
Toronto, Ont.

ROYAL COMMISSION ON BANKING

AND FINANCE

Hearings held at Ottawa,
Ontario, on Wednesday,
October 24th, 1962.

THE COMMISSION

The Honourable Dana Harris Porter
Chief Justice of Ontario
Toronto, Ontario - Chairman

Mr. W. Thomas Brown, M.B.E.
Investment Dealer
Vancouver, British Columbia

Mr. James Douglas Gibson, O.B.E.
Banker
Toronto, Ontario

Mr. Gordon L. Harrold
Agriculturalist
Calgary, Alberta

Mr. Paul H. Leman
Corporation Executive
Montreal, Quebec

Mr. John C. MacKeen
Corporation Executive
Halifax, Nova Scotia

Dr. W. A. Mackintosh
Vice-Chancellor
Queen's University
Kingston, Ontario

Mr. H. A. Hampson - Secretary

Mr. Gilles Mercure - Joint Secretary

Ottawa, Ontario
Wednesday,
October 24th, 1962

--- At 9.20 A.M. the hearing commenced.

SUBMISSION OF

CANADIAN LABOUR CONGRESS

APPEARANCES

Mr. Donald MacDonald - Secretary-Treasurer Canadian Labour Congress

Mr. Russell Bell - Acting Research Director Canadian Labour Congress

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THE CHAIRMAN: We will now consider the brief of the Canadian Labour Congress. We have all read this brief with considerable care and we are very much impressed with the amount of work and thought that has gone into it and wish to congratulate you on the brief that you have presented.

As you understand, it is not necessary to read the summary unless you so desire; having read the brief generally we proceed with questions and enter into a discussion on various aspects of the points that you have raised. Is that satisfactory to you?

MR. MacDONALD: Yes.

THE CHAIRMAN: We will now proceed.

MR. MacDONALD: My Lord Chief Justice and members of the Commission, I should perhaps first of

all say on behalf of the Canadian Labour Congress, as one of the bodies who requested the establishment of your Commission, that we welcome this opportunity to appear before you and present our views.

As we have indicated in the opening paragraph of our submission, we believe that the operations of the monetary and financial institutions of this country have an important bearing on two matters with which we are very much preoccupied at the moment and which cause great concern; namely, unemployment and economic growth. That is, you have no doubt noted from your perusal of the document that we have laid great emphasis on these aspects of our submission.

I perhaps at this point should also express my regrets that for the reasons set forth in our official submission it is not possible for us to be as helpful as we would have otherwise liked to be with respect to some particular matters about which you have inquired, such as the activities of unions as borrowers and lenders in the capital market, and the information which you indicated was desirable with regard to pensions operated on behalf of workers. We would have liked to have provided the desired information, but, as we have explained, it is not possible within our structure to obtain it as easily as might be assumed. However, we have tried to the best of our ability to set forth, as was indicated was desirable, our basic philosophy with regard to the central questions facing the Commission and, as you have already indicated, My Lord Justice, we are

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relieved to find that we are not expected to read the entire submission or even the summary, and we take it for granted that what will be done is questioning with regard to matters that are contained in the submission itself.

I am not an economist and certainly would not wish to have any misunderstanding with regard to my qualifications; therefore, any technical or economic questions that arise will be dealt with by our acting director of research, Mr. Russell Bell, who is here with me, and I will, of course, endeavour to deal with any matters of basic policy or structure or function of the labour movement in general or the Canadian Labour Congress in particular.

I think that is all we want to say at the moment, My Lord Justice and gentlemen, and as far as we are concerned we are prepared to receive and try to cope with any questions that might arise from your perusal of our submission.

THE CHAIRMAN: Thank you very much.

COMMISSIONER LEMAN: Mr. Chairman, before we get into the part of the discussion dealing with the views expressed in your brief, could I ask you very briefly to tell us what are the main functions of the C.L.C. as such?

MR. MacDONALD: Yes, I think this would be helpful and questions of this kind will place our position in better perspective, perhaps.

The Canadian Labour Congress is a national labour centre. It is not a union in itself, it is a

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MR. MacDONALD: Yes, I think this would be helpful and questions of this kind will place our position in better perspective, perhaps.

The Canadian Labour Congress is a national labour centre. It is not a union in itself, it is a

federation of unions who banned together on a voluntary basis and the Congress' main functions are that of a co-ordinating and legislative body at the national level, although it does interest itself and is active in practically all activities that come within the scope of labour, and today that is pretty broad.

That is an extremely brief statement of our position, but if you wish me to amplify it, I would. We have a million and 70 thousand members and approximately 116 affiliated national and international unions, others of which are regional and provincial, and with some 20 odd thousand in unions which are directly chartered by the Congress itself.

We operate throughout the country and we have established ourselves I think in almost every nook and cranny of Canada and we maintain five regions throughout the entire nation with staffs and headquarters in each of these regions and conduct our organizational and educational work largely from these regional operations.

We are also extremely active -- I don't know if this is of interest to the Commission, but perhaps it should be mentioned in passing -- we are also extremely active at the world level; we are one of the founding members of our world-wide body, the International Federation of Free Trade Unions, and participate very actively in this work.

I don't know if there is anything more I could add usefully at the moment, and if this gives

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rise to any further questions I would be delighted to try and answer them, of course.

COMMISSIONER LEMAN: You say in your brief that there are a few areas where you don't have certain statistics that the Commission have asked for; these are not, perhaps, statistics which you regularly assemble and therefore they were not available, but does the Congress, does the Research Department of the Congress gather statistics of its own or just work with the available published statistics from D.B.S. and other sources, or do you assemble statistics of your own?

MR. MacDONALD: We do both. Do you wish to answer that?

MR. BELL: Yes, we do both, as our secretary-treasurer has just said. On the one hand we, of course, use very directly the official statistics put out by the government, the D.B.S. statistics and, of course, we have access to statistics put out by other governments agencies, and so on, but in addition to that we also collect statistics with regard to matters of a collective bargaining nature and our Research Department supplies information with respect to collective bargaining statistics, and the various unions that are interested in such are getting such data.

COMMISSIONER LEMAN: Now, in another field, what are what you call the areas of authority of the Congress over the member unions?

MR. MacDONALD: I suppose that would hinge on the definition of "authority", but actually we are

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MR. MacDONALD: I suppose that would hinge on the definition of "authority", but actually we are

composed almost exclusively of autonomous affiliates; about 70 per cent of our membership and roughly the same percentage of our affiliate unions are international in character, operating in both the United States and Canada, and the vast majority of the others are national.

Each of these autonomous affiliates conduct their own affairs and their affiliation with the C.L.C. is on a purely voluntary basis. However, we do naturally require the affiliates and the members to support the constitution of the organization of which they are a part and to subscribe to the principles and policies, and where they do not do so, of course -- like all other democratic organizations -- we naturally have to enforce such discipline as in the opinion of our convention is warranted.

COMMISSIONER LEMAN: But so long as they want to remain members they can, but they also can withdraw if they want to?

MR. MacDONALD: Yes.

COMMISSIONER LEMAN: As long as they want to remain members, very broadly, what sort of things do they have to agree to? Is it in economic matters, for instance? Is there anything of an economic nature?

MR. MacDONALD: Not with respect to collective bargaining; collective bargaining as such is purely within the jurisdiction of the individual unions. We do, however, make our economic position known through our convention, through democratic action, and our economic views are assumed -- because of the

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manner in which they are adopted and approved -- they are assumed to reflect that of all our membership and all our affiliates unless we have some indication to the contrary, which has never been the case.

COMMISSIONER LEMAN: Well now, would you restate for us, Mr. MacDonald, the very broad stand which you take on what are the objectives of economic policy that the Congress supports?

MR. MacDONALD: I think that Mr. Bell is much better qualified to deal with that than I am.

MR. BELL: The general economic objectives of the Canadian Labour Congress, is that the question, sir?

COMMISSIONER LEMAN: Yes. I wouldn't say it is the objectives of the Canadian Labour Congress; it is the economic objectives which the Congress feels are the right ones for the country to pursue.

MR. BELL: At our last convention the Canadian Labour Congress adopted a statement on economic policy, and this particular statement set out as the main goal, the main economic goal or objective of the Congress, as being full employment. This has been our primary interest, as you would naturally expect, and we have consequently tried to formulate what is in our opinion appropriate policies to achieve this goal of full employment.

COMMISSIONER LEMAN: That is the primary one. Are there secondary ones, too, which you feel go along with this.

MR. BELL: Yes. I was going to add, sir,

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MR. BELL: Yes. I was going to add, sir,

that while we advocate as our primary goal, full employment, at the same time we are advocating measures to bring about that primary goal and we are also concerned that such measures should also lead to stability, to economic stability.

We are concerned with the whole subject of price, of course, and consequently we have tried to formulate policies that would bring about full employment with the maximum price stability.

COMMISSIONER LEMAN: Well now, do you believe that you could put some kind of quantitative measures on what you call full employment and reasonable price stability, the best possible price stability and growth of the economy. Do you think you could put figures on what you would think are satisfactory achievements in those fields?

MR. BELL: Well, as far as full employment is concerned, we have generally taken the position that if we have no more than 3 per cent of the labour force unemployed, then we have virtually full employment.

COMMISSIONER LEMAN: Could you elaborate on that a little bit? You use that figure of 3 per cent; is that because of the nature of that index?

MR. BELL: The 3 per cent figure has to be an arbitrary one, as you appreciate but, on the basis of our information and knowledge, we have assumed that given the kind of circumstances, the economic circumstances that prevail in this country -- the economic and social circumstances, I should say --

that while we advocate as our primary goal, full employment, at the same time we are advocating measures to bring about that primary goal and we are also concerned that such measures should also lead to stability, to economic stability.

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that 3 per cent or less of the labour force unemployed would virtually amount to full employment.

There is, of course, a certain amount of frictional unemployment that takes place in a country, and particularly in a country like this, and consequently some allowance has to be made for that, and I think that if one makes this kind of an allowance that the 3 per cent figure is not an unreasonable one.

Perhaps you would like me to briefly elaborate on what we mean by frictional unemployment?

COMMISSIONER LEMAN: We have had representations made on that. I was wondering if you would go so far as to say, however, that if you should go beyond 3 per cent unemployment -- in other words, 2 per cent or one per cent -- you have passed what you would call the full employment base, and then you begin to have trouble with the other objectives which you want to pursue.

MR. BELL: Well this, of course, depends on the economic circumstances. We had for quite a number of years, as you are undoubtedly aware, in the earlier post-war years this less than 3 per cent labour force unemployment. As a matter of fact, the percentage of unemployment has been quite a bit less at certain times, less than 3 per cent. Of course, there were certain conditions that gave rise during that period to full employment and I am sure that you do not want me to go into all of the reasons why we had full employment during the earlier post-war years

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because I am sure you are fully acquainted with those reasons and I am sure that those reasons have been discussed before your Commission previous to our attendance here.

COMMISSIONER LEMAN: What I was driving at was this; you believe, for instance, that 3 per cent in Canada represents a full employment position and that the moment you exceed that it will have a direct effect, for instance, on the pressure on prices?

MR. BELL: Well this, of course, is very difficult to say.

COMMISSIONER LEMAN: It has a direct relationship?

MR. BELL: Yes, because what you are hinting at -- if I might put it this way -- once you get below the 3 per cent level then you are getting into what some economists call over-full employment.

Now, where or just at what stage this so-called condition of over-full employment is attained is exceedingly difficult to say. Conceivably, if you have the entire labour force employed, if you had no unemployment whatsoever, that this presumably would indicate a state of over-full employment because it wouldn't take into consideration the normal frictional unemployment.

COMMISSIONER LEMAN: What I am thinking about is that when you have separate objectives these have to be kept in balance, you say, and I am wondering how you believe that this balance works in practice?

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MR. BELL: Well, I would just like to make this point, sir. As you are probably well aware, there has been a considerable amount of controversy over the past few years on the subject of whether or not you can have full employment accompanied by price stability.

This argument has been in full force in the United States, I think in particular, for the past few years. It has been the subject of very considerable controversy, and it is a controversy, of course, which has not been settled by economists, such as many other controversies. We have taken the position, though, that if it is not possible to have, say, complete price stability and at the same time full employment, then our priority would be given to the full employment.

I am not suggesting that it is not possible to have complete price stability and, at the same time, full employment. Quite frankly this is an exceedingly difficult question to answer. I do not think anybody, really, is in a position to answer this, but if price stability and full employment are not mutually attainable, then we would certainly give preference to full employment. This is a position which has been taken by many European governments and their economists. As you are probably aware, price increases have been much more considerable in Europe, particularly in the last few years, than here in Canada and the United States. As a matter of fact, both in Canada and the United States during the last few years we have had virtual price stability. It is quite true that there have been some upward rises to the consumer price index but I personally take the position that if you have a small rise in the consumer price index, for example, that this does not necessarily indicate a state of inflation because there are certain upward

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biases in the consumer price index. I am sure this has been discussed before your Commission on previous occasions. One, of course, is in connection with the increased quality of goods and services. Consequently, a slight rise in the consumer price index, the kind of rise we have been having over the past few years, may simply reflect that improvement in the quality of goods and services. If that is the case, I do not think you could call that inflation.

COMMISSIONER LEMAN: And this moderate price increase at the consumer goods level, you feel, is in terms of what percentage-wise, an acceptable rise which would not spell inflation, one per cent, two per cent or what?

MR. BELL: Yes, I would say one or two per cent would not indicate a state of inflation. Perhaps if the consumer price index went up two per cent it would indicate a slight inflationary tendency in the economy, but if we could experience full employment conditions with that condition, this would not be a matter of great concern.

COMMISSIONER MACKINTOSH: May I interject a question at this point?

COMMISSIONER LEMAN: Certainly.

COMMISSIONER MACKINTOSH: I take it from what you say, Mr. Bell, you recognize this full employment measurement, which you say is a very great simplification, and that you would have to understand what was behind, say, the three per cent. You may have a national three per cent which includes, we will say, an unfortunately

[illegible]
[illegible]
occasions. One, of course, is in connection with the increased quality of goods and services. Consequently, a slight rise in the consumer price index, the kind of rise we have been having over the past few years, may simply reflect that improvement in the quality of goods and services. If that is the case, I do not think you could call that inflation.

COMMISSIONER LEMAN: And this moderate price increase at the consumer goods level, you feel, is in terms of what percentage-wise, an acceptable rise which would not spell inflation, one per cent, two [illegible]

MR. BELL: Yes, I would say one or two per cent would not indicate a state of inflation. Perhaps if the consumer price index went up two per cent it would indicate a slight inflationary tendency in the economy, but if we could experience full employment conditions with that condition, this would not be a matter of great concern.

COMMISSIONER MACKINTOSH: May I interject a question at this point?

[illegible]

COMMISSIONER MACKINTOSH: I take it from what you say, Mr. Bell, you recognize this full employment measurement, which you say is a very great simplification, and that you would have to understand what was behind, say, the three per cent. You may have a national three per cent which includes, we will say, an unfortunately

heavy rate of unemployment in the Nova Scotia coal mines and also in the British Columbia lumber industry, arising out of particular problems affecting those industries, in which case I take it you would agree that the remedy was not to try and raise aggregate demand further but rather to go to work on the Nova Scotia and the B.C. problems to see what you could do with those industries so that you may have an even three per cent which represents over-employment in some regions, in the sense that the proper approach to it is not one of stimulating further aggregate demand. Would you agree substantially with that statement?

MR. BELL: Yes. When we were discussing the three per cent, of course, we were thinking in terms of a national average and consequently it would be necessary to take into account regional unemployment problems. As a matter of fact, if you had only three or possibly even four per cent of the labour force unemployed and it could be demonstrated that the principal contributing factor there was regional unemployment such as the kind you have just suggested, then the measures required to deal with that situation undoubtedly would be quite different from the measures required to deal with an over-all unemployment problem.

COMMISSIONER MACKINTOSH: I am not arguing against your proposition. I am just suggesting this to make it more realistic.

MR. BELL: Quite true.

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MR. HALL: Quite true.

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out of the diagram and into reality.

COMMISSIONER LEMAN: One could put on a graph a few curves and see some correlations which might be just coincidence instead of cause and effect. You say that for the last four or five years we have had what you consider a reasonable price stability in Canada. Prior to that we had had a fairly constant price increase for a few years, had we not?

MR. BELL: Yes. I would just say for the purpose of being as specific as possible that we have not had, in my opinion, what you would call any significant inflation since 1957. As you are undoubtedly aware, the last period of what I would call significant inflation took place during the period 1955 up to 1957. That particular inflation was really an investment inflation precipitated by corporations that were expanding their plant production capacity at a very fast rate. This was the main reason why we had inflation at that time, but since then I do not think it would be accurate to describe us as experiencing any significant inflationary pressures.

COMMISSIONER LEMAN: In practice the views of the Congress on these economic objectives and how to achieve them and how to maintain a reasonable balance -- how does this work down to your members when they formulate their own objectives in terms of wage policies for their own members? In other words, is there any consideration given or is there guidance given by the Congress to the members in terms of national objectives when they formulate their policies?

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MR. MacDONALD: Only in the sense, as I explained before, that when the economic policy of the Congress is adopted it is adopted in convention with representation from all our affiliates, and it is supposed to serve as a guide to them and certainly to be given due consideration. However, as I also explained, they are completely autonomous and we do not have any authority or any control over any of our affiliates with respect to their collective bargaining policies. In this our nation is different from at least some others that one can think of. Conditions vary so greatly within regions and within industries that under existing conditions it would be utterly impossible, I think, as is evidenced, to achieve any degree of uniformity or standardization with regard to collective bargaining objectives. There are, as all of us know, certain countries where that desirable objective has been obtained, but our circumstances here would not permit it.

COMMISSIONER LEMAN: What I am thinking of is this. Do you believe there can be some relationship between wage policy and employment; in other words, may one have an effect on the other? If there is too fast a rate of increase in average wage levels can that have a bad effect on employment?

MR. BELL: Could I just counter that, sir, by asking you what you mean by too rapid a rise in wage levels?

COMMISSIONER LEMAN: No, I will let you use your own definition of that.

MR. MacDONALD: Only in the sense, as I explained before, that when the economic policy of [illegible] with representation from all our affiliates, and it is supposed to serve as a guide to them and certainly to be given due consideration. However, as I also explained, they are completely [illegible] not have any authority or any control over any of our affiliates [illegible] policies. In this our nation is different from at least some others that one can think of. Conditions vary so greatly within regions and within industries that under existing conditions it would be utterly impossible, I think, as is evidenced, to achieve any degree of uniformity or standardization with regard to collective bargaining objectives. There are, as all of us know, certain countries where that desirable objective has been obtained, but our circumstances here would not permit it.

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MR. BELL: Well, of course, the conventional argument is, as I am sure you are well aware, that if wage rates rise more rapidly than productivity increases, that this is a contributing factor to inflation, and so on. From all the available evidence we have not found that, -- I am sure this is what you wanted me to get around to, sir, and perhaps I am going a little too far afield but just stop me if I am -- from all the available evidence we have we have not found that wage increases have been too rapid in Canada. We have not found that wage increases have been a contributing factor to inflation. As a matter of fact, the last few years indicate perhaps even the contrary, for wage increases, that is annual average wage increases, in this country in the past several years have actually been going down rather than up. I am talking about average annual earnings increases. These have been going down over the past several years. I do not know whether this answers the question properly or not.

COMMISSIONER LEMAN: You are talking about the amount of wages divided by all the people in the country, or all the workers?

MR. BELL: Yes, I am talking about average annual increases in wages. I am speaking on a national basis now.

COMMISSIONER LEMAN: For those who are working or for all the population?

MR. BELL: No, for those who are employed in industry.

COMMISSIONER LEMAN: So, the rate of increase has gone down?

MR. BELL: The rate of increase per year, precisely.

COMMISSIONER LEMAN: And when did the curve turn? What year did this begin to flatten out?

MR. BELL: I am sorry. I have not got the figures with me but this occurred in 1961, in 1960, and in 1959. I am speaking now from memory only, so I can be subject to correction. But if I am not mistaken the average annual increase in earnings in Canada in 1959, for example, was about 3.6 per cent. Then in 1960 I think this was 3.5 per cent, and in 1961 I believe it had actually dropped to 2.8 per cent. As I said before, those figures I am giving from memory.

COMMISSIONER LEMAN: Since you have a quantatitive objective in terms of reasonable price stability in terms of, say, one or two per cent per year, not being really inflation, etc., would you have a quantatitive objective for wage increases too? What would be the satisfactory rate of increase per year, to keep the objectives in balance still? I want to keep concentrating on this equilibrium between objectives, you see.

MR. BELL: I think I would answer that question by saying we have not any evidence, for example, that average annual earnings increases have been exceeding productivity increases. It is quite true that productivity data are extremely difficult to

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come by in Canada. There are no real official productivity data published by the Dominion Bureau of Statistics, as is the case in other countries such as the United States, but on the basis of unofficial data that have been produced it would seem to indicate that wage increases have not been out-stripping productivity increases, as is commonly charged.

COMMISSIONER LEMAN: I understand that and I am not disputing it at all. What I am wondering is whether you think a certain rate of increase in both productivity and wage increases is attainable here. Do you believe it is attainable on average? I am not talking about this year but as a long-run view.

MR. BELL: I will have to come back to what our Secretary-Treasury, Mr. MacDonald, has just told you, that it is difficult to formulate objectives simply because of the structure of our trade union movement. A given union, for example, negotiates for a wage increase or improvements in working conditions in accordance with what it believes is feasible or practicable within its industry, and of course this goes on right across the board.

Now, what one union thinks is a reasonable objective may differ considerably from what another union thinks is a reasonable objective, simply because of the different conditions that obtain in the different industries. So, consequently, it would be very, very difficult to formulate a national objective with regard to increases, that is one that

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would have any real meaning.

COMMISSIONER LEMAN: Considering that your members are autonomous how do you think they view these things when they set their own goals? Do they think in terms of wage increases for the members who are working and are members of the union, all by themselves in isolation, or do they make some kinds of correlation, do you think, in setting their own policy between what could be the effect of a certain rate of increase in that particular industry and its effect on future prospects of employment in that industry? Do you think they pay any attention to these things?

MR. MacDONALD: I do not believe any general answer can be given to that question. There are some of our unions that are quite large and employ very competent technical staff whose advice and information, of course, is available to them.

I think in those instances those particular unions would have regard to all aspects of all economic situations both in relation to their own particular industries and that of the national level. In those instance, of course, we have very, very small unions as well, and I think there they would not have available to them as expert information as would be the case in respect of the larger ones and, of course, this situation can vary as well.

In some instances some of our small unions will turn to us and ask us for information and data which will, of course, be provided through the medium of our research department and our economists, and other unions will not. So, really within the framework of our structure it is almost impossible to give one general answer to the question.

COMMISSIONER MACKINTOSH: May I ask if in relation to these smaller unions in addition to furnishing them with consumer price indices and various other statistical information whether the Congress would also supply advice in respect of collective bargaining objectives in the particular setting of the time at which they are asking, or is that service restricted simply to the medium of a formal request?

MR. MacDONALD: It would be restricted to the medium of formal request. We would not gratuitously provide advice to them with regard to their collective bargaining objectives unless it was desired by them.

COMMISSIONER MACKINTOSH: Do they in fact

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COMMISSIONER MACKINTOSH: Do they in fact

sometimes ask for that?

MR. MacDONALD: I would say infrequently.

COMMISSIONER LEMAN: Well, I realize how difficult it would be to get too precise with regard to any particular union bargaining for wages in a particular industry. I think it would be taking a great responsibility to tell them: well now, we think you should restrict your demands to just so much, because it will have certain effects, and it is very difficult to predict exactly what the effects would be, but in the Congress itself when you have conventions, when you get together -- once a year, is it?

MR. MacDONALD: No, biannually; every two years.

COMMISSIONER LEMAN: Are those things talked about in terms of general national goals?

MR. MacDONALD: Oh, yes and, of course, in addition to our convention, and perhaps I should have elaborated previously, we have an executive council which is our policy body during the period between conventions which meets frequently -- well, I should say four times a year on the average-- and such things are discussed, of course. There is an exchange of views between the various unions and groupings represented on the executive council.

COMMISSIONER LEMAN: Well, now, I have a question in respect of what you believe in a period of high demand. Let us talk again in terms of pre-1957 and post-1957. Lets take a period of very high demand where perhaps the result achieved in terms of

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employment was not so much a matter of policy but as the result of the fact that we were in a period of high demand, and without having any particular employment policy you just had a very high rate of employment. In a situation like that what do you think is the relevant weight of union action in getting higher wages for the members as against just the general atmosphere of high demand? What do you think produces, or has produced the increase in the level of wages? What proportion of it was due to action by unions and what proportion of it was due just to the economic atmosphere in which people were bargaining and working?

MR. BELL: I think, sir, that one would have to take a given period and examine that period. You referred to the pre-1957 period. Well, I think perhaps the first two years, as a matter of fact, just prior to that; the latter part of 1955 up to approximately the end of 1956 is a period that is worth examining. We had, of course, a very rapid expansion and very rapid economic growth rate in that period, but I think that a careful examination would indicate that the primary reason for that rapid growth was the fact that corporations in Canada because of certain demand expectations decided to expand, and it was because of this expansion -- a pretty excessive kind of expansion, as a matter of fact -- that gave rise to full employment and also gave rise to very rapid economic growth. I think in that particular period that this was the primary, or that this is the primary explanation for the very

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rapid growth rates and high level of employment.

COMMISSIONER LEMAN: Well, how would you analyse the thing after; from 1957 to 1961, say?

MR. BELL: From 1957 to 1961, this, of course, was an entirely -- or, has been an entirely different kind of situation. Since 1957 there has been a lack of effective demand in the economy. There has not been sufficient demand to sustain full employment or adequate growth rates. As you know, our economic growth over these last few years has been among the lowest of the advanced industrial countries. As a matter of fact, because of this slow-down, or because of the reduction in aggregate demand, the Gross National Product, or the per capita Gross National Product is even less today, or it was less in 1961 than it was in 1956. There was not any increase over that period; in other words in output of goods and services per man, woman and child. Consequently this period could thus be described as one of a very considerable deficiency in aggregate demand.

I appreciate, of course, -- I do not want to over-simplify this because I appreciate that there are other problems; regional problems which have to be taken into account. However, at the same time we have had in this period a very serious over-all national problem which was not the case in the preceding years of our post-war period.

COMMISSIONER LEMAN: Well, not talking in terms of what is practical to suggest to any particular

rapid growth rates and high level of employment.

COMMISSIONER LEMAN: Well, how would you [illegible] the [illegible] from 1957 to 1961, say?

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COMMISSIONER LEMAN: Well, not talking in terms of what is practical to suggest to any particular

union that is bargaining at the time, do you think, however, that any change in economic activity such as we have seen, and we think now in terms of pre-1957 and post-1957 when there was a real change -- this seems to have been the pivot year -- there is any relationship between the rate of wages, or the average level of wages and the level of employment or unemployment in the country? Do you think it would be reasonable to expect that if wages came down some in such a situation that it could have some effect on employment?

MR. BELL: No, I would answer that very definitely. I do not think that it would be possible as a matter of fact to produce evidence to indicate that a reduction in wages would make any contribution to employment. On the contrary, I would go so far as to say that if we had any significant cut in wages in this country we would simply aggravate our unemployment problem.

I mentioned a moment ago that one of the reasons for the economic state that we have had over the past few years has been the deficiency in aggregate demand. One of the demand forces operative in our economy, of course, is wages, and if wages are cut then obviously this reduces, or this would reduce purchasing power, and a reduction in purchasing power would, of course, further lower unemployment.

Now, I know the arguments that have been raised on the other side. Those arguments are well known here, and to put them very briefly, those who

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propound these arguments profess to believe that wages have risen rapidly and have contributed to competitive difficulties, and that is competitive difficulties in respect of foreign imports, but I find that those who make these arguments have yet to produce any evidence to substantiate them.

COMMISSIONER LEMAN: Well, why is it that in this particular field there should not be, or cannot be a response; a classical type of response to demand in terms of wage levels? For instance, what I had in mind is why does not the inter-play of the sort that one man earning $3 an hour would not create as much demand as two men earning say $2.50?

MR. BELL: You are posing a hypothetical problem, sir.

COMMISSIONER LEMAN: Yes, naturally I am making it hypothetical. I am trying to illustrate the type of action I have in mind. Why is it that there is such rigidity all of a sudden and wages are not responsive to demand in times of a slackening in the economy?

MR. BELL: I think to some extent that wages are. This is difficult to quantify, but I think that to some extent wages are responsive to demand conditions. As a matter of fact there is evidence that there is a relationship between the two. However, at the same time, if you are suggesting that there is not the same relat onship today as existed say several decades ago, I would admit this and very happily so because the kind of free inter-play of market forces which

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you are suggesting would simply lead to the kind of instability which we experienced very severely in years gone by which I personally would not like to see repeated.

COMMISSIONER LEMAN: Well, would you describe the extent to which you say they are responsive? How does it work in practice? What is the response?

MR. BELL: What is the response?

COMMISSIONER LEMAN: You said that wage rates are responsive to demands.

MR. BELL: I said to a certain extent.

COMMISSIONER LEMAN: Yes, that is it, and I said to what extent.

MR. BELL: To a certain extent there is. There are all kinds of areas where presumably there is a greater relationship, or more of an inter-play in market forces in this respect than in other areas. It is very, very difficult to specify and be precise.

COMMISSIONER MACKINTOSH: Is not the short answer that while instances of wage reductions are rare, instances of demand for much more moderate increases in periods ofslack demand are fairly frequent?

MR. BELL: During slack demand periods you are suggesting that wage rate increases are less?

COMMISSIONER MACKINTOSH: Yes.

MR. BELL: Yes, that is very definitely true. As a matter of fact the figures for the last several years -- the figures I quoted a little while ago from memory -- bear that out quite clearly.

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MR. BELL: During slack demand periods you are suggesting that wage rate increases are less?

COMMISSIONER MACKINTOSH: Yes.

MR. BELL: Yes, that is very definitely true. As a matter of fact the figures for the last several years -- the figures I quoted a little while ago from memory -- bear that out quite clearly.

COMMISSIONER LEMAN: Well, now, I think you told us a little earlier that we were not very well equipped with figures to measure productivity in the economy as a whole.

MR. BELL: Quite right.

COMMISSIONER LEMAN: This can be done by industry quite well, can it not?

MR. BELL: Well, businessmen whom I have talked with in respect of this subject tell me that this is an exceedingly difficult thing to do. As a matter of fact, not very long ago I happened to sit in on a discussion where representatives of a particular company were in attendance. They indicated that measuring productivity in their particular company was an exceedingly difficult thing to do. This seems to be a typical reaction. Productivity is not easy by any means to measure with any kind of accuracy.

I would like to see this, however. We would like to see our Dominion Bureau of Statistics make an effort at publishing such data. I think that their argument is that because of the imprecise data they have they would not want to release it. However, on the other hand the Bureau of Labour Statistics in the United States does make an effort in this direction.

COMMISSIONER LEMAN: This stems from the difficulty of measuring to what extent better tools have been supplied to the workers, or why is it so difficult to measure productivity?

MR. BELL: Well, it depends on the particular industry. As you know, in the case of some industries

where you have a product mix it is exceedingly difficult under these circumstances to measure productivity. Whereas, in certain other industries, for example, in mining, the measurement of productivity would be a much less difficult thing to undertake. Sometimes, as a matter of fact, it is even difficult to get common agreement on figures of productivity, and what productivity actually means.

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COMMISSIONER LEMAN: Until everyone is satisfied that we can get reasonably good figures on this score, it seems a little hopeless to try to adopt a wages policy that would be related to this factor of productivity?

MR. BELL: Most precisely, yes. Absolutely. Even if we were in a position to bargain nationally or centrally it would be very difficult to formulate -- at least, in my opinion it would be very difficult to formulate what wage goals should be for a given period without having accompanying productivity data that could be relied upon. And as a matter of fact, productivity data, although certainly significant, are not the only determinants, or would not be the only determinants, either, in the matter of formulating wage policies. There are other determinants as well.

COMMISSIONER LEMAN: It would not necessarily be the only anchor, but it could be one anchor?

MR. BELL: That is right.

COMMISSIONER MACKINTOSH: I am not sure that this is entirely relevant, but out of curiosity I would like to ask a question. We had, some weeks ago, a Swedish economist, Erik Lundberg, before us. He told us that in Sweden they followed, with, I understood, the full support of labour, a policy of uniform wages across the country, with no concessions to depressed industries or depressed areas; that the policy was to force the industries either to achieve an adequate productivity, or get out; and, with a measure giving a variety of government assistance, to

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force the population to move if there was no alternative in the sense of productive employment in the area.

I take it this would be looked upon as pretty strong medicine in this country.

MR. MacDONALD: Doctor, your conception is a little bit different than ours as to what obtains in Sweden, as a matter of fact. As a matter of fact, just about a year ago now I went into Sweden for the specific purpose of studying into that situation, and that is not my concept of it. More recently we had, as perhaps you are aware, three distinguished Swedish gentlemen, the president of the Swedish L.O., which is the national labour centre of the manual workers in Sweden; Mr. Kugelberg, who is the head of the S.A.F., the Swedish Employers Federation, and the secretary of the Labour and Social Department, who would be comparable to our Deputy Minister of Labour. They visited us here and attended a tripartite conference between government, labour and management. It is true that at the national level in Sweden -- and we very much admire them for their attainments in this regard -- the two basic parties get together with the blessing of the third one, the government, and in the light of the very best data available which is acceptable to both of them, they arrive at a conclusion as to what the standard or over-all increase should be for the subsequent year. Then that, of course, is translated down to the affiliates and the component parts of the employers organization of S.A.F., and it has tremendous moral suasion. But I

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do not know of any use of force in the situation.

COMMISSIONER MACKINTOSH: Do not misunderstand me. I did not mean that the government intervened. My understanding is the same as yours, that to a surprising and attractive degree they are able to get a general policy out of the negotiations between employers.

MR. MacDONALD: Exactly.

COMMISSIONER MACKINTOSH: But a further understanding was that out of this group came a fairly ruthless pressure to raise wages in the depressed areas, accepting as the bitter alternative that unemployed should be thrown on the government doorstep, rather than that they should be nursed along in the area at what they considered inadequate wages.

As I say, this is a little off the track of our argument, but it interested me as a very bold policy which I think in this country would probably require to be even bolder.

MR. MacDONALD: We are great admirers of what is going on in Sweden, and we are paying a great deal of attention to it at the moment. We are delighted to find that our interest is now becoming shared by government and many employers. Actually, the philosophy, as I understand it, does not quite parallel your description. There is a process of rationalization which accompanies the overall collective bargaining position within what they term the labour market. But the motivation, as I understand it, is considerably different.

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As a matter of fact, it is not to throw the unemployed workers out, when jobs fold up because of the rationalization process, on the doorstep of government. Quite the contrary. My understanding is that under their programme, which is a very precise and planned programme to eliminate unemployment, the whole effort is bent in the direction of creating new forms of productive employment within the economy for these individuals.

I think that it is one of the great beacons of the western world today, what they are accomplishing in this connection. I saw at first hand on both my visits to Sweden what is being done, and I never at any point detected any force or coersion in the situation. Quite the opposite. The employers and the employees organizations, both their organizations, agree on the elimination in some instances of uneconomic sections of industry. They do this well in advance of its closing and follow through very carefully with their programme of providing employment either within that locality, if it is possible, and in many instances they have been successful in creating another industry where the previous one has been closed, or else encouraging -- that is quite true: I certainly would not use the word "force" because there is no force involved -- encouraging workers to retrain either for other available employment in the immediate area or to transfer to available employment in some other area.

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to establish themselves and get themselves operating on an efficient, economic basis, and for the workers are marvellous, because it includes their families and everything else; and the assistance that becomes available to employers under these circumstances, I think it is amazing, to say the least.

COMMISSIONER MACKINTOSH: I think you misunderstood me in part, Mr. MacDonald, in repeating this. I do not know whether I used the word "force" or not; but in any case, all I meant was a firm policy. Further, I did not go on and say what the government did with the co-operation of the unions and management about the unemployed. I was merely struck with the idea that they were not afraid to confront the economy with the prospect of unemployment in order to achieve a re-arrangement, some re-orientation of industry.

MR. MacDONALD: It would be quite true to describe it as a very bold and imaginative policy which is implemented with the co-operation, the complete co-operation, of all three groups within the economy.

COMMISSIONER MACKINTOSH: Oh, entirely.

MR. MacDONALD: Yes.

COMMISSIONER LEMAN: Mr. MacDonald, do you have any figures that would prove whether this policy has worked, in fact, in terms of the differences in wage levels in various industries in Sweden, compared with the variations in Canada between industries? Is it much more standard or is it much more uniform

in Sweden than it is here?

MR. MacDONALD: The wage levels?

COMMISSIONER LEMAN: Yes.

MR. MacDONALD: Yes, the wage levels are, I think. There is less differential within the wage structure than there would be in Canada. That is my impression. We do have data that could be available. I do not have it at the moment, obviously, because I did not foresee the trend of this discussion. But they do make available a tremendous amount of information in this connection.

COMMISSIONER LEMAN: This greater uniformity that Mr. Lundberg was explaining to us, as Dr. Mackintosh pointed out, was the result of a conscious policy; it was not just happenstance.

MR. MacDONALD: No; it is a very careful, well thought-out, planned policy.

THE CHAIRMAN: We will adjourn for a fifteen minutes break.

--- Short recess.

THE CHAIRMAN: We will now resume.

COMMISSIONER MACKINTOSH: Mr. MacDonald, your major policy recommendation, I take it, is what you call somewher a "massive expansion in the public sector of the economy". I take it that by "massive" you mean very great. Is there any other reason why you used the word? What just is the connection of the word "massive"?

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MR. MacDONALD: [illegible]

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MR. BELL: What we have in mind here, sir, is a very large, very substantial development of those things which lie in the public sector, and we have very briefly enumerated in our brief those things, slum clearance, urban redevelopment, public redevelopment, conservation of resources, housing, hospitals, schools, provincial universities, and so forth.

This is certainly not, by any means, an exhaustive list. We have set these out as examples. All of them are very important examples, but if we were really presenting a more detailed presentation we would have many others to include. We believe that the so-called public sector of our economy has been very seriously neglected now for many years; that there is a real deficiency here; and that consequently by concentrating more in this particular area we would accomplish two objectives. One objective would be the supplying of, or the fulfilling of needs in this area, and secondly, the fulfilling of these needs would in turn lead to an increase in employment.

COMMISSIONER MACKINTOSH: Do you imply at all that this policy would be cyclical in its implementation, or is your concern here growth?

MR. BELL: Our concern here is more for achieving full employment and increasing the growth rate. It is quite true that the question of cyclical policy does enter into it to a certain extent, but I should make it very clear that we are not simply advocating this programme on an ad hoc basis. We believe that there are real deficiencies here, and

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there are going to be deficiencies here for a considerable period of time to come. Consequently, we believe that we should allocate more of our resources -- I should not say "allocate more of our resources". Let me put it this way: I think that now with the kind of economic conditions that we have, where we have considerable unemployment in this country, we can afford to undertake these projects without reducing effort in the private sector of the economy.

COMMISSIONER MACKINTOSH: We have had others before us who were inclined to argue that a greater improvement in aggregate demand could be achieved by tax reduction, rather than increase in expenditures. What are your views on that?

MR. BELL: Could I just ask, what tax reductions do they have in mind? Are they concerned with personal income taxes, corporation taxes?

COMMISSIONER MACKINTOSH: Yes, I think they were pretty catholic in their views of taxes; personal, corporate commodities.

MR. BELL: Could I deal first of all with the suggestion that has been made by many, that a reduction in corporate income taxes would lead to a solution of our economic problems. We do not believe that this would be the case, for this reason. There is already very considerable unused industrial capacity in Canada, and consequently tax concessions -- right across the board, that is, -- would not under those circumstances likely lead to a capital expansion.

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The reason that capital expansion is not taking place today -- in other words, the reason that the level of private capital investment is down by comparison with its post-war peak, which was in 1957, is simply because of the lack of effective demand for our goods.

So consequently making tax concessions to corporations, which this school of thought proposes, is not going to solve that problem at all. If there were actually a lack of private capital funds, if this were the problem, then of course our answer would be very much different. But there is no lack of capital funds in Canada.

Now, those who argue that tax concessions are necessary in order to enable Canadian industries to modernize their equipment, are overlooking in my view a very important factor, and that is that we have an excellent system of depreciation allowances in Canada and these depreciation allowances are available to the corporations to modernize their equipment if they deem it necessary to do so, so consequently I just failed to understand the logic behind the argument or the school of thought that thinks that a reduction in corporate tax is all that is required to get our economy going again.

COMMISSIONER MACKINTOSH: We are talking here in terms of aggregate; some effect would fall if some corporations and some industries had unfilled demand and could start the expansion process; it is not necessary that there be an additional demand over the total to start the process of expansion?

MR. BELL: Some corporations, sir?

COMMISSIONER MACKINTOSH: Some corporations, some industries have need for, presumably, investment and can expand, but I am not sure you are correct in saying that capital is readily available. It is in certain circumstances if we import enough.

MR. BELL: The point which I was trying to make, sir, is that generally speaking our corporations have sufficient capital funds available to them if they wish to expand.

I would like to just refer again to the 1955 to 1957 period where we had very considerable

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capital expansion and yet the tax "burden" was just as heavy then as it is now -- possibly slightly heavier, as a matter of fact -- but this didn't deter them from expanding. Now, the reason that they expanded then, of course, was because they had considerable demand expectations. Unfortunately, these demand expectations didn't exactly materialize, but at least they anticipated that there would be effective demand for an increased output, and therefore they went ahead and expanded.

Now, I think that the same would be true today if corporations in Canada had demand expectations, but they don't.

COMMISSIONER MACKINTOSH: And as large profit margins?

MR. BELL: Pardon?

COMMISSIONER MACKINTOSH: As large demand expectations as they had in the previous period and as large profit margins?

MR. BELL: The reason their profit margins are lower now than they have been in previous years is largely because they are operating at less than capacity. If they were operating at full capacity or near full capacity their profit margins would go up considerably.

COMMISSIONER MACKINTOSH: Plus something like I would think over those years from 1956 about a 30 per cent wage increase?

MR. BELL: I am sorry, I didn't hear you. Over which period?

COMMISSIONER MACKINTOSH: Over the latter half of the 1950's, isn't that right?

MR. BELL: Over the latter half of the 1950's?

COMMISSIONER MACKINTOSH: Yes.

MR. BELL: A wage increase of how much?

COMMISSIONER MACKINTOSH: Aggregating about 30 per cent?

MR. BELL: Just what period, though, 1955 to 1960?

COMMISSIONER MACKINTOSH: Yes, or 1961.

MR. BELL: I haven't got the figures here, the aggregate figures, but I doubt very much that it would be that much over that particular period.

COMMISSIONER MACKINTOSH: My recollection is that it is substantially of that note, and that profits are about even or down a bit.

MR. BELL: Profit margins now?

COMMISSIONER MACKINTOSH: Yes.

MR. BELL: Well, profit margins are lower now, quite true, than they have been in previous years, but then again I think this is almost solely because industry in so many cases is operating at much less than capacity. Certainly I think this is the primary reason for this somewhat reduced profit margin.

COMMISSIONER MACKINTOSH: What about personal income taxes?

MR.BELL: As far as personal income taxes are concerned, there may be a very good reason for

reducing them to a certain extent, particularly in the lower income classes, because such reductions would lead to an increase in purchasing power.

I think, as a matter of fact, that this might be a very feasible approach to take, but at the same time I think that something more is needed than that alone, and that something more in our view is an expansion and a very considerable expansion in the public sector of our economy.

We are not advocating this particular approach and please do not misunderstand us; we are not saying for one moment that this is the sole solution to our problems; far from it. At the same time, we believe that it should be given very considerable emphasis because it is in this area of our economy where there is such a great demand for goods and services, public demand for goods and services, and in fulfilling this demand we could achieve a lot in the way of reducing unemployment. And, of course, as the economists point out, expansion in this particular area would also have a very important multiplier effect on the private sector as well, so that the net effect would be a very considerable increase in the total aggregate demand in our economy.

COMMISSIONER MACKINTOSH: Of course, you have undermined my question to some extent by mentioning the universities in this list, and having declared my interest in the matter ---

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the Minister of Finance -- whom I have not consulted -- would say, "This is an attractive thing but I have already acquired, created or inherited a very substantial deficit on my budget, which it might be argued comes in part from the adoption of policies of increased social welfare payments, which are comparatively rigid, and related to population to a considerable extent and therefore create -- along with other items -- create deficits when revenues should falter or fall."

Does this represent any change? I mean, does the recommendation you are making represent any change in the point of view of the Congress as between welfare payments and what you might call social capital expenditures, anything other than a difference between the two periods?

MR. BELL: I am not sure that I understand the change in our policy with respect to a different ---

COMMISSIONER MACKINTOSH: I am assuming that you thought increased old age pensions -- this sort of thing -- a good thing. Now, I think the Minister of Finance would say, "If I didn't already have this deficit which comes from these comparatively rigid or population related expenditures, I would like to go into these social capital expenditures, they attract me."

Are these the alternatives, or is your contention that you can go along and have them both?

MR. BELL: Our contention would be that we can go along and have them both and for this reason --

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MR. BELL: Our contention would be that we can go along and have them both and for this reason --

which I think is a very sound economic reason -- that as long as we have considerable unused capacity in our economy, industrial capacity and resources, and a considerable number of unemployed, that a planned deficit budget to finance this so-called expansion of the public sector would have -- well, it would have this very beneficial effect, but apart altogether from actually accomplishing these particular projects, it would have the effect of raising the national income and, as a matter of fact the result of raising the national income would, of course, result in increased tax revenues to the government and out of the increased tax revenues the government would be able to pay off or liquidate the interest payments and principal involved in financing these projects.

In other words, by adopting this particular approach we would over a period of a relatively few short years raise very considerably the national income and, of course, once full employment had been attained, then obviously deficit financing or a deficit budget wpuld have to be replaced by a balanced budget in order to avert inflationary pressures, but until full employment has been attained or as long as there are unused resources, both human and physical, then increasing deficit financing for the purpose of doing these things would certainly not be inflationary.

So consequently we can afford to do these things now because of our unused resources, and at the same time we can retain our social welfare programmes or even improve upon them, as a matter of fact.

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as long as we have considerable unused capacity in our economy, industrial capacity and resources, and a considerable number of unemployed, that a planned deficit budget to finance this so-called expansion of the public sector would have -- well, it would have this very beneficial effect; but apart altogether from actually accomplishing these particular projects, it would have the effect of raising the national income and, as a matter of fact the result of raising the national income would, of course, result in increased tax revenues to the government and out of the increased tax revenues the government would be able to pay off or liquidate the interest payments and principal involved in financing these projects.

In other words, by adopting this particular approach we would over a period of a relatively few short years raise very considerably the national income and, of course, once full employment had been attained, then obviously deficit financing or a deficit budget would have to be replaced by a balanced budget in order to avert inflationary pressures, but until full employment has been attained or as long as there are unused resources, both human and physical, then increasing deficit financing for the purpose of doing these things would certainly not be inflationary.

So consequently we can afford to do these things now because of our unused resources, and at the same time we can retain our social welfare programmes

COMMISSIONER MACKINTOSH: I don't want to explore it in detail, but the specific objects which you have mentioned would require very extensive and specific agreements among the national government, the provinces and the municipalities, since different governments are responsible for different expenditures, and your recommendation I think goes in the direction of almost a complete consolidation of national governmental expenditure in the sense of including all three levels of government, in which those responsible for government in the past have found very real difficulties.

MR. BELL: Some of these things, of course, might come under the sole jurisdiction of the Federal Government but it is quite true, as you say, that many of them would involve appropriate arrangements among the three levels of government.

COMMISSIONER MACKINTOSH: In other words, it couldn't be massive unless it is?

MR. BELL: Yes. You mentioned the municipalities and I would like to mention -- and you are probably aware of this -- that the Federation of Mayors and Municipalities have rather frequently in their submissions to the Federal Government pointed out and documented the great needs that exist at the municipal level in Canada and many of the things we are proposing, as a matter of fact, would have their endorsation.

COMMISSIONER MACKINTOSH: Of course, they are not alone and that practice is still before us;

they pointed out the great urgent needs of their particular group.

MR. BELL: If I might just make this comment; many have said -- including the highest official levels -- that these things are desirable but they usually raise the question, "How does one go about financing them?" There is nothing particularly unconventional in the method of financing that we are suggesting, and just to repeat again -- because I think it is exceedingly important that we make this point clear -- that there is no reason why the Federal Government cannot use a planned budget deficit for the purpose of financing these things given the kind of economic conditions that we have now.

Now, of course, we wouldn't advocate this method of financing if we had full employment. If these particular objectives were considered to be socially desirable, given a period of full employment, then obviously you would have to resort to taxation because otherwise you would be creating a demand in the economy that couldn't be met because all of your resources were fully employed, but in Canada today this is far from being the case. Therefore we feel that it is economically feasible to advocate deficit financing, and a considerable amount of deficit financing, for the purpose of financing these things.

I am sorry for talking too long, but I would just like to revert to the point that you made or the point that you raised a little while ago, and that is with regard to the kind of deficits that

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MR. BELL: If I might just makethis comment; man [illegible] -- that these things are desirable but they usually raise the question, "How does one go about financing them?" There is nothing particularly unconventional in the method of financing that we are suggesting, and just to repeat again -- because I think it is exceedingly important that we make this point clear -- that there is no reason why the Federal Government cannot use a planned budget deficit for the purpose of financing these things given the kind of economic conditions that we have now.

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Canada has been incurring in recent years.

Now, to a large extent these deficits -- and, as a matter of fact, I think you more or less explained or certainly implied this -- that these deficits were to a large extent really more involuntary than voluntary; involuntary in the sense that the Minister of Finance just did not anticipate revenues falling off. He found that his revenues fell off too much to meet his expenditures.

COMMISSIONER MACKINTOSH: To some degree they are automatic, but I cannot assume that the automatic feature of them was not foreseen and planned, but I don't know. They are in the system, if you want to put it that they, but whether they are deliberately in the system or by inadvertence is not for me to judge.

MR. BELL: The contrast between what has actually happened and what we propose is that we would aim for a certain level of growth, whatever level of growth is necessary to provide and sustain full employment.

Now, some have suggested an average annual 5 per cent growth in Canada would be necessary to provide full employment. I doubt that anybody knows just exactly what percentage growth rate is required at the present time, but whatever that is or whatever it is assumed to be, we would work or we would want the government to work towards achieving that growth rate and thus provide or bring about the conditions necessary to provide full employment.

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COMMISSIONER MACKINTOSH: I think 5 per cent was a bit ambitious. However, that is a matter of judgment.

COMMISSIONER GIBSON: I should like to ask a few questions about your section on exchange rate policy. You say in fact that you prefer a free type of exchange rate because it allows for adjustment of balance of payments to the needs of the domestic policy. I understand the theory that says this should be so, but it does not seem to have worked that way recently. Have you any explanation of why our exchange rate, when we had a free one, stayed so high and so obviously out of line with our domestic economic interests? This has been true for several years.

MR. BELL: Yes, I agree that when we had a fixed exchange rate our dollar was over-valued.

COMMISSIONER GIBSON: No, this was when we had the free exchange.

MR. BELL: When we had the free exchange rate?

COMMISSIONER GIBSON: Yes.

MR. BELL: It was over-valued, taking into account the considerable imbalance in our current transactions ---

COMMISSIONER GIBSON: And taking into account our domestic interests and use of our resources, and so on.

MR. BELL: Precisely. The government apparently recognized this, but our view is that the government adopted the wrong approach or measures to

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apparently recognized that, but our view is that the government adopted the wrong approach or measures to

bring about a devaluation of our dollar when it was at a premium over the American dollar. We believe that if the government had adopted what we considered appropriate policies for dealing with our unemployment situation and our low economic growth rates at that time, instead of forcing the devaluation of the dollar as it did, these appropriate measures which would have brought lower interest rates in Canada and thus reduced the interest rate differential between this country and the United States, that the borrowings that were taking place by our municipalities and provincial governments, and so on, in the American money market, would have been considerably reduced.

As a matter of fact, this would have reduced their incentive to borrow in the New York money market. Consequently, this would have relieved pressure on our Canadian dollar and our dollar would have been devalued in a gradual and orderly way without the artificial intervention that took place as the result of government action at that time. Consequently, I do not think we would have had a premium on our dollar at all if these steps had been taken, but it was apparent that the government decided that all that was really required was to bring about the reduction in the value of the dollar; it did not favour the expansionary policies that would have automatically brought this about. Consequently it had to step in, or thought it had to step in and, what I call, artificially devalue the dollar. I think this is where we got ourselves into a real dilemma,

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a dilemma which to a certain extent we are still in.

COMMISSIONER GIBSON: The government was running a pretty substantial deficit during most of this period when we had a significant amount of unemployment and felt our dollar was over-valued. I should like to ask you: do you really think that is the whole story? How about the problem of the foreigners' attitude towards this country and their continued desire to put money in and buy things here despite the fact we have this big balance of payments deficit? In other words, we have to take into account our very close proximity to the United States and the tremendous movements of money into Canada which had occurred. Do you not think this complicates the problem?

MR. BELL: It is a very complicated problem.

COMMISSIONER GIBSON: Complicating so far as explaining this phenomenon?

MR. BELL: I am not quite sure that I follow you.

COMMISSIONER GIBSON: You gave a pretty straight forward and simple -- I mean simple in a polite sense -- explanation of why you thought we had too high an exchange rate. I am suggesting to you that it is a good deal more complicated than that.

MR. BELL: The point, if I may reiterate this, is that I think the reason we had an over-valued dollar -- an over-valued dollar that certainly was not in our interests -- was that we were importing certain capital that was not necessary to be imported, and that capital

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MR. BELL: The point, if I may reiterate this, is that I think the reason we had an over-valued dollar [illegible] and that capital

was coming in through the borrowings taking place by our provincial and municipal governments and, to a certain extent, by certain corporations. They borrowed from the American money market because of lower interest rates there, and it was to their advantage to do so, but our position is that if the government at that time had been pursuing expansionary policies for the purpose of solving the unemployment problem, it would not have had to intervene in the foreign exchange rate markets as it did. If our interest rates had been reduced as the result of expansionary policies, as a result of expansion of money supply which needed to be expanded, for example, at that time, then I think there would not have been any inducement on the part of our people to have gone down to the United States money markets.

COMMISSIONER GIBSON: I can see this in terms of borrowing in New York but I am not at all sure I can see this in terms of the kind of deliberate capital inflow that was coming from the United States to buy existing assets, and this is something which was quite important during this period as well. The motivation there does not seem to be just an interest rate matter.

MR. BELL: The interest rate factor is very important in so far as public bodies are concerned.

COMMISSIONER GIBSON: That is true.

MR. BELL: I would say it is exceedingly important, and it seems to me that at that time it was these borrowings that were just sufficient to bring

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that extra pressure to bear on the Canadian dollar to maintain it at a premium.

COMMISSIONER MACKINTOSH: May I interject at this point, Mr. Gibson? I avoided this question of the discipline of foreign markets in my discussion with you, Mr. Bell, but I should like to interject that, without discussing the total validity of your proposition, it would be much more attractive to a Minister of Finance if he could start it at a time when his budget was balanced and when the rate of exchange was still at a premium. Now, he has been visited with, or has created, a very substantial deficit and his rate of exchange is already at a substantial discount, and the practicial difficulties of going on from there are very substantial; at least I am sure they would appear so to a Minister of Finance.

COMMISSIONER GIBSON: Well, carrying on in the same area, having fixed an appropriate rate of exchange with the International Monetary Fund, which presumably fits our national interests, our domestic economic interests,reasonably well, do you believe it is in our interest to change that policy now, or are you simply saying as a long-range policy you prefer a flexible or free rate of exchange?

MR. BELL: As we have indicated, or tried to indicate in our submission, what we are afraid of with a fixed rate of exchange is that it will tie our hands when it comes to employing what we consider appropriate internal domestic policies to expanding

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economic growth.

COMMISSIONER GIBSON: With a 92½ dollar do you not think there should be a floor? Our rate does give us a fair amount of latitude.

MR. BELL: I could counter by asking you just where our dollar would be if we had a floating exchange rate?

COMMISSIONER GIBSON: I do not know.

MR. BELL: Nobody else does either. But I think it would be a pretty fair assumption that our dollar would not be too far off where it is now if we had a floating exchange rate. Certainly it would probably be around 90 cents anyway. So, I do not think there would be any real difference as far as the actual extent of the devaluation was concerned, whether we had a floating or a fixed exchange rate, but if I could come back to the real reason why we are concerned about a fixed exchange rate, it is that government fiscal policies may very well have to be tailored to supporting that fixed exchange rate, and at the same time those particular policies may be running contrary to our internal interests such as full employment and suitable economic growth rates.

COMMISSIONER GIBSON: Do you not think the sort of rate we have does give us a reasonable degree of latitude? Surely there is some level at which we should want to support the exchange rate. You said you were interested in reasonably stable prices.

MR. BELL: We had floating exchange rates between the year October, 1950, when we went off the

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MR. BELL: We had floating exchange rates between the year October, 1950, when we went off the

fixed exchange rate, up until about the end of 1960 when the Minister of Finance began to tinker with the exchange rate. I think that a floating exchange rate served this country's economic interests quite well.

COMMISSIONER GIBSON: Do you not think the exchange rate was a little high, say, in 1958 on in terms of our economic interests? We had unemployed resources in that period and our imports were pretty high and our exports were not high enough.

MR. BELL: Yes, I certainly agree with that, but then, as I pointed out before, I think that if certain internal policies had been pursued in this country at that time we would not have had a premium on our dollar, even with a floating exchange rate.

COMMISSIONER GIBSON: In other words, you have a very strong preference for a free rate, but would you agree that in certain circumstances it is desirable to support the rate in the national interests?

MR. BELL: If you have a floating exchange rate you do not support it, do you?

COMMISSIONER GIBSON: The point I am getting at is that if you had a nice, even movement as you did from 1950 to 1960, the idea of supporting it does not really come up. The only idea that really came up in that period was it was too high towards the end of the period. But suppose you changed the rate under pressure, would you not agree there are times this would involve implications in terms of price increases, to a degree that is more than sensible in

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the interests of the country?

MR. BELL: I would suggest that the exchange funded account would be sufficient to modify any fluctuations that would arise if we were on a floating exchange rate basis. However, if there was considerable pressure on the dollar it might be necessary, as a matter of fact, for the government to step in and give support to the dollar if the dollar began to fall. But I just do not envisage that taking place. I do not think, as a matter of fact, there would be very much difference now from what we experienced in the 1950's with regard to maintaining a fairly even gear as far as our exchange rate is concerned, if this trend of events had not been set off by the government towards the end of 1960.

COMMISSIONER GIBSON: Yes, but whatever you may think of the events that have occurred, we are where we are right now and one has to have a view about this situation.

MR. BELL: I appreciate that.

COMMISSIONER GIBSON: I will suggest to you that we reached a position where it became desirable to define our exchange rate at some level, and that this is why we have a fixed rate.

MR. BELL: As we suggested in our submission, it might not be possible to revert to a floating exchange rate, certainly at the present time or perhaps for some time to come, but in thinking of alternatives it seems to us that we cannot go back to a floating exchange rate then we should try to secure approval

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from the International Monetary Fund to have a bit wider latitude for our exchange rate.

At the present time, as you are well aware, the International Monetary Fund requires us to maintain our fixed exchange rate within a very narrow latitude, one percentage point on either side. In our view this is too small a margin, given the kind of pretty unique economic circumstances with which we are faced in Canada.

COMMISSIONER GIBSON: I would not disagree with your view. It sounds very sensible. But why do you think in putting up this point of view, which obviously has appeal from the Canadian outlook, that the Fund would be particularly interested in considering it? I mean, this would necessitate the United States and leading nations of Western Europe going along with this idea, and some of them, the European countries, have been through rather great exchange rate difficulties and they had to put up with the rules and regulations of the Fund. Do you think they would be willing to change this to suit us or to suit other countries which might be in a similar position?

MR. BELL: Of course, I am not in a position to know just what kind of a response we would get from the International Monetary Fund, but they certainly made a major concession to us in September, 1950, when we had particular circumstances there which they believed warranted making certain accommodations with us, and it seems to me that our official representatives should be making a pretty strong representation

to the International Monetary Fund to see the kind of difficulties that we are now encountering, and persuade them that the kind of pretty rigidly fixed exchange rate we have just does not harmonize with our financial policies generally.

COMMISSIONER GIBSON: I was just wondering if you had any view on our chances of doing this.

COMMISSIONER MACKINTOSH: May I interject there, perhaps on the other side of this amicable discussion. Without committing myself to an overall view, nevertheless I think there is a case for saying that the floating exchange rate in 1955-56 or thereabouts was a period of great capital imports and accommodated itself to what we now look upon as over-investment, over-borrowing from an external source and gave no signal at all that anything was wrong, whereas a fixed exchange rate would have given some kind of signal and pointed the finger at the economic circumstances which were later to cause us very considerable difficulty.

I just interject that so that the floating exchange rate will not have quite the halo on it that you have been giving it.

COMMISSIONER LEMAN: Mr. Gibson, may I also interject something here?

COMMISSIONER GIBSON: Yes.

COMMISSIONER LEMAN: I am a little surprised by Mr. Bell's confidence that it is a reasonable assumption that the Canadian dollar would be at about 90 cents U.S. now if it was left free. Suppose, for the sake of discussion, we go along with you on that and say that right now it would be about 90 to 92 cents if it was free. Where would it go, if the kind of deficit and expansionary policies you suggest we should adopt, were adopted? What would it do to

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the dollar?

MR. BELL: You are aprehensive that the dollar might fall below 90 cents if the kind of domestic expansionary policies which we are pressing for are implemented; is that right?

COMMISSIONER LEMAN: I am asking you, what do you think it would tend to put the dollar at? If you admit that right now it would be at 90 cents without this expansionary policy, what would happen to it with the expansionary policy?

MR. BELL: With a floating exchange rate?

COMMISSIONER LEMAN: Yes.

MR. BELL: With a floating exchange rate I do not know that there would actually be much change, because if there were certain tendencies or pressures, downward pressures, on our dollar, with the floating exchange rate you would have a self-corrective mechanism. For example, if the government were to pursue the kind of expansionary policies that we are interested in, there might of course be a tendency for imports to rise, because usually whenever you get an expanding economy in Canada there is this tendency for imports to increase. It is for this reason, or this is one of the reasons why we are interested in having a floating exchange rate; it is to correct that kind of situation, because with a floating exchange rate, if there was a tendency for imports to rise, then the effect on our dollar would eventually bring about a correction for a better

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MR. BELL: With a floating exchange rate?

COMMISSIONER LEMAN: Yes.

MR. BELL: With a floating exchange rate I do not know that there would actually be much change, because if there were certain tendencies or pressures, downward pressures, on our dollar, with the floating exchange rate you would have a self-corrective mechanism. For example, if the government were to pursue the kind of expansionary policies that we are interested in, there might of course be a tendency for imports to rise, because usually whenever you get an expanding economy in Canada there is this tendency for imports to increase. It is for this reason, or this is one of the reasons why we are interested in having a floating exchange rate; it is to correct that kind of situation, because with a floating exchange rate, if there was a tendency for imports to rise, then the effect on our dollar would eventually bring about a correction for a better

balance between our imports and our exports.

But with a fixed exchange rate, I find it very difficult to conceive of a fixed exchange rate helping a situation like this. If you have an expansion of your economy which leads to a rise in imports, there is no change in your external rate; consequently you have not got your exchange rate acting as a deterrent to excessive imports. With a floating exchange rate, I think it does serve as a deterrent to excessive imports.

COMMISSIONER GIBSON: As Dr. Mackintosh says, with a fixed rate you do get a real signal. Your reserves start to go down if your balance of payments is turning more against you. This tells you that you have a problem that you need to do something about. In this context I would like to ask you this question. Supposing Canada does not find it practical to go back to a free rate and does not succeed in getting wider latitude from the I.M.F. Would you feel that your plans for domestic expansion would have to be altered to some degree to fit that change? You said this is what you would like, but supposing you do not get it? Would you feel that your suggestions for public works, tax reductions, and so on, would have to be tailored to some extent?

MR. BELL: It sounds repetitious and it probably is repetitious of what I have said; but I am apprehensive that a fixed exchange rate will -- I do not know just to what extent, of course -- put certain restraints on domestic policies.

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COMMISSIONER GIBSON: It does put limits on them. Whether they are restraints, or not, depends on the circumstances.

MR. BELL: Yes. This, incidentally, is the reason why we are so hep, I suppose, on the floating exchange rate, because with a floating exchange rate you do not have these restraints. For example, with a floating exchange rate our government would not now be aiming for a balanced budget. Given the kind of circumstanes we now have, aiming for a balanced budget is the most unrealistic approach possible.

COMMISSIONER GIBSON: I think the minister suggested the other day that the deficit was going to be $570 million. That is not quite balanced.

MR. BELL: No. It is quite true that there is a difference between having a balanced budget and aiming for one; but the fact that they are supposedly aiming for a balanced budget indicates to me that certain restraints -- well, undoubtedly certain restraints have been imposed upon them. The mere fact that they have borrowed from the International Monetary Fund and the Import-Export Bank, the Bank of England, and so forth, undoubtedly must have involved certain obligations.

I do not need to tell you, sir, that when one goes to a bank and borrows money there are certain conditions laid upon the borrower. Undoubtedly the same thing takes place with regard to transactions

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between our government and these foreign banks.

COMMISSIONER GIBSON: But do not we ultimately have to accept a certain amount of external discipline if (1) we want to obtain resources from abroad on a reasonable basis and (2), and this is much more important, if we want to have reasonable stability and confidence in our own currency at home? Is there not a certain discipline attached to this? Is it not one of the facts of life that we have to accept? Whether we have a floating rate or a fixed rate, this still applies, does it not?

MR. BELL: It is a discipline, though, that carries with it a very high price, as far as employment is concerned. I think you will agree with this.

COMMISSIONER GIBSON: You have to weigh one against the other, in the circumstances. It seems to me that it is absolutely vital to have confidence in your own currency. I would say this was one of the things you must have; you must have confidence in your money.

MR. BELL: But I am suggesting that if we had been on a floating exchange rate today, if what has happened had not happened, we would not have the exchange rate difficulties that we have at the present time.

COMMISSIONER GIBSON: We are looking at a situation, and there is the situation.

MR. BELL: Yes, but we do not know yet, as a matter of fact, whether we are out of this exchange

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MR. BELL: Yes, but we do not know yet, as a matter of fact, whether we are out of this exchange

rate difficulty or not. As a matter of fact, we could easily get into another situation in the relatively near future where pressure was brought to bear against our dollar, even though it is now at a fixed exchange rate.

COMMISSIONER MACKINTOSH: May I interject here? I think, with some over-simplification, your argument adds up to this, that in undertaking this programme of expansion, this massive investment, unless the exchange rate goes down the spill-over of imports will seriously reduce your multiplier effect?

MR. BELL: Unless the exchange rate goes down?

COMMISSIONER MACKINTOSH: Yes.

MR. BELL: With a floating exchange rate, of course, it would go down, in the circumstances.

COMMISSIONER MACKINTOSH: And this would preserve more of your multiplier effect?

MR. BELL: That is right; this would act as a deterrent effect against imports and you would have more of a multiplier effect against a balanced economy.

COMMISSIONER LEMAN: What do you think the International Monetary Fund authorities want? Do you think they have these rules because they want Canada to wallow in a very tough, unacceptable level of economy activity, or is it just because they feel there are certain, appropriate ways of trying to improve your economy, and certain less appropriate ones?

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MR. BELL: Let me make very clear, first of all, that I am not prejudiced against the International Monetary Fund. It serves a very useful purpose. But at the same time, I do not think that uniform rules can be -- in all areas, that is -- laid down by the International Monetary Fund, because of the very wide economic disparities between countries.

I think one of the chief functions of the International Monetary Fund is to see that countries do not get involved in competitive exchange depreciation. This is something I would be very, very much opposed to, because we experienced this years ago and all of us suffered very adverse consequences from that kind of thing. But at the same time, I think there are other areas where a certain degree of flexibility has got to be permitted. That is why I think Canada should at least try to secure some concession from the International Monetary Fund. It may not be feasible to revert to a floating exchange rate, from their point of view; but at the same time, I think they have got to give us some more flexibility with respect to our exchange rate.

COMMISSIONER LEMAN: It is one per cent up and down now. How much per cent up and down would really help you much?

MR. BELL: No, I am not concerned with the extent of devaluation at this point, because with a floating exchange rate I do not think there would be very much difference between what the rate is now and what it would be.

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COMMISSIONER GIBSON: But what margin do you think the fund ought to give us? I think that is what Mr. Leman was asking.

MR. BELL: The margin either side?

COMMISSIONER GIBSON: Yes.

MR. BELL: This is purely arbitrary, but we have thought in terms of five points on either side, which would provide a greater degree of flexibility than the one point on either side now provides for us.

I would like to make just one additional comment here, because we have pointed this out in our submission. A country like Canada -- and others too, as a matter of fact -- would be able to function with a fixed exchange rate if there was not this problem of international liquidity. If this problem could be solved, then it would be much easier for us to operate on a fixed exchange rate. As a matter of fact, under those circumstances, a fixed exchange rate might be quite feasible.

COMMISSIONER GIBSON: This just gives you more time to make the necessary adjustments; it does not alter the fact that you have to adjust yourselves to the conditions of the outside world. Having a big reserve means that you get more room to move around in, but you still have to make your adjustments which your balance of payments position forces on you; isn't that correct?

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COMMISSIONER GIBSON: The difference, though, in a floating exchange rate and more liquidity is that a floating exchange rate can, in theory, make any adjustment required; but perhaps it would result in a greater depreciation in currency; whereas the greater liquidity gives you time to make the necessary adjustment. I think that is the essential difference.

MR. BELL: Supposing, sir, that a floating exchange rate resulted in a greater depreciation of our currency. What damaging effect do you foresee from that condition?

COMMISSIONER GIBSON: I was asking you that question because --

MR. BELL: I do not see any particular thing to worry about.

COMMISSIONER GIBSON: You are not concerned about the rise in price level that would result from that? Over a period of time our price level would adjust itself to the exchange rate. It does not do this rapidly, but it does do it.

MR. BELL: I do not follow this. I do not see that it would have any contributing effect to price increases.

COMMISSIONER GIBSON: It did after the war, for example. Our price level adjusted itself to the American price level and the American exchange. If our rate goes down to a lower rate, in terms of the American dollar, we are going to have higher prices than the Americans, more or less related to

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MR. BELL: But, again, our primary concern here is that with a fixed exchange rate our government may be hampered or handicapped in pursuing the policies that are required to bring about full employment or to substantially reduce the amount of unemployment that we have in this country. So consequently, if this reasoning is valid, we could not possibly accept a fixed exchange rate, precisely for that reason.

COMMISSIONER GIBSON: Why could you not accept a 92½ cents dollar? Surely that gives a reasonable margin?

MR. BELL: I am sorry, sir.

COMMISSIONER GIBSON: Why could you not accept a 92½ cents dollar? This gives us quite a margin; it is a reduction of 12 points from the previous level.

MR. BELL: Yes, but this is not my concern at all. I can accept a 92½ cents dollar, but it is the fact that the fixed 92½ cents dollar prevents us from having the necessary internal flexibility.

COMMISSIONER GIBSON: When you say "prevents us", you are sort of suggesting that it ought to be even more?

MR. BELL: No; it is the fact that it is a fixed rate, not the fact that it is at 92½ cents or 90 cents.

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COMMISSIONER MACKINTOSH: What you mean is that in the future it may have this preventive effect?

You do not feel it is inhibiting now, but some time in the future it may?

MR. BELL: Yes. I am sure I do not have to explain this to Mr. Gibson. With the kind of economy that we have, with the kind of open economy that we have, a floating exchange rate, it seems to me, is much better in adapting our internal needs and requirements to our balance of payments. This is what bothers me: If we had a more closed economy, such as the United States has, which is not nearly as dependent on trade as we are -- after all, we are proportionately much more highly dependent upon trade than the United States --

COMMISSIONER GIBSON: Even the Americans are being subjected to a certain amount of international economic discipline now.

MR. BELL: Yes, but their circumstances are quite different from ours.

COMMISSIONER GIBSON: Oh, yes.

MR. BELL: If it was not for these particular circumstances, which you well know are the American commitments abroad, which are the cause of their imbalance on current account transactions, then they would have no particular problem. But that is something else again.

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MR. BELL: With the kind of open economy we have had, or comparatively, it seems to me that a fixed interest rate is not going to work very well unless, of course, we are willing to accept a comparatively high level of unemployment. This is something, of course, which we certainly cannot under any circumstances accept.

COMMISSIONER GIBSON: I have a couple of more questions in this area, namely, as to the use of foreign capital to balance our current account deficit. Do you have any particular views about the scale of the capital inflow that is occurring to balance our accounts, and which is still occurring and has been over the last five or six years?

MR. BELL: I think we would have to answer that in this way. First of all imported capital is necessary to promote economic expansion, and quite apart altogether from the balance of payments problem import capital is essential. If the government were to adopt measures to drastically reduce imported capital then I think the dire result would be a very safe aggrevation of the whole problem, so we have a natural tendency to place pretty great emphasis on the contribution that the capital makes toward expanding jobs.

Now, at the same time we are, of course, concerned about foreign capital. We have some concern about foreign capital taking over Canadian concerns, but perhaps we do not view it with the same apprehension that many do. There are many charges, of course, that

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foreign capital is resulting in direct interference with the Canadian economy, and if that is true, of course, then it certainly is a valid objection. We are just concerned that any measures that would reduce the import of foreign capital to the extent that those measures would contribute to unemployment would certainly not be looked upon very happily.

COMMISSIONER GIBSON: If the deficit were reduced by importing less or exporting more, or both, this would presumably provide more jobs in Canada?

MR. BELL: Yes, if this could be done we could reduce our current account deficit through increasing our exports.

COMMISSIONER GIBSON: Or reducing our imports?

MR. BELL: Or reducing our imports. Then, of course, this would be a very happy solution, but as long as we cannot do it this way we are going to be dependent to a considerable extent on foreign capital, perhaps unfortunately, but nevertheless to look at it from a purely realistic view I am afraid this may well continue to be the case.

COMMISSIONER GIBSON: You are not concerned about the theory that says it is the import of foreign capital that has tended to create a big import deficit.

MR. BELL: Yes, I have heard this theory expressed many times. This may to a certain extent be true, but I have yet to see as a matter of fact --

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it may be true but on the other hand I have not seen any substantial documentation.

COMMISSIONER GIBSON: Thank you, that is all.

COMMISSIONER BROWN: I would just like to ask one question in respect of this matter of import of capital before going on to something else. If this country did go into a sort of deficit financing as you suggest, what effect do you think this would have on the people who are putting the capital into the country at the moment? Do you think it would change their attitude at all?

MR. BELL: You are suggesting that foreign investors might lose confidence in us if we continue to have a budget deficit?

COMMISSIONER BROWN: I am not suggesting anything, I am asking you for your opinion. What would you think their reaction would be, or do you think there would be any reaction?

MR. BELL: I do not know that there would be. I know it is frequently suggested that one of the reasons why foreigners have lost confidence in our dollar is because of the kind of budget deficit we have experienced over the past few years. I would like to offer a few comments on that because I think this has been greatly exaggerated.

I think that one of the main reasons why there has been a lack of confidence in the past few years -- there are a number of reasons, of course, but one is that there simply are not the investment

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opportunities in Canada that there were before. Our economy has slowed down. It is not as attractive a place for investors as it was in the earlier years. I think this is certainly an important explanation for whatever loss of confidence investors have now in the Canadian dollar.

Now, those who repeatedly focus all the blame on budget deficits here are obviously overlooking the fact that European governments are accustomed to having budget deficits. As a matter of fact, we have documented that in our brief. Countries like France, Germany and Sweden -- all the rapid growth countries -- as a matter of fact frequently have deficits. Some of them have had budget deficits stretching consecutively over a decade. There is no great apprehension on the part of businessmen over there, they take it for granted. Businessmen, governments, professional economists view budget deficits as a matter of fact as being necessary to sustain this kind of economic growth. I appreciate the fact that there are other reasons for the rapid economic growth that has taken place in European countries, and I am not trying to say that budget deficit is the only factor, and far from it, but at the same time budget deficit has played a significant role in these countries as pointed out by these people themselves. In North America I think we have a totally unrealistic fear of deficit financing, or using our budget in the way that it is customarily used in these countries.

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COMMISSIONER LEMAN: May I ask something here? You do make a reference to this fear of deficits particularly in paragraph 58 of your brief. I am a little puzzled by the analysis of the comparison between public debt and personal debt. You say that one of the reasons why there is this fear is that people think of public debt in the same sense as they think of personal debt, and then you say that public debt, because of its self-liquidating nature should not be looked upon in the same light as personal debt.

MR. BELL: Yes.

COMMISSIONER LEMAN: Well, now, don't you think that intelligent personal debt is also of a self-liquidating nature?

MR. BELL: It depends on the personal debt. I can think of a lot of personal debts that are not intelligent.

COMMISSIONER LEMAN: But when it is done for productive purposes presumably it is self liquidating in the same sense that national debt is, is it not?

MR. BELL: Well, sir, the only point that we are trying to make here is that there is a distinction, or that there is some distinction between the kind of debt contracted by governments or by corporations for the purposes of expanding; well, in the case of governments for the purpose of expanding or bringing about full employment and expanding economic growth and the national economy, and in the case of corporations obviously for the purpose of expanding profits. That is

COMMISSIONER LEMAN: May I ask something here? You do make a reference to this fear of deficits particularly in paragraph 58 of your brief. I am a little puzzled by the analysis of the comparison between public debt and personal debt. You say that one of the reasons why there is this fear is that people think of public debt in the same sense as they think of personal debt, and then you say that public debt, because of its self-liquidating nature should not be looked upon in the same light as personal debt.

MR. BELL: Yes.

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why we point out that debt financing or deficit financing used this way is not only self-liquidating but very profitable in terms of expanding income, whereas a lot of individuals have the tendency to think, and quite rightly so, as a matter of fact, that when they go into debt, the debt that they contract is really not contributing to their income at all. An individual family that goes into debt to buy a television set, obviously that debt is not contributing to income. On the contrary, as a matter of fact, it is cutting down future income.

So there is a tendency on the part of many individuals to equate this kind of personal debt with government debt so we often find it necessary to try and draw a distinction between the two.

COMMISSIONER LEMAN: Well, did you know that we have been told in this Commission not very long ago by people who were sitting right where you are sitting now that a television set is for a productive purpose? I just wanted to see exactly what you meant by this. Would you regard external debt the same as personal debt in that sense? Would you distinguish it from national debt that is strictly inside?

MR. BELL: Well, of course, there is a very clear distinction between national or internal debt and external, but external debt itself can, of course, play a part; it can be very productive in the sense that it leads to an expansion of one's economy. As a matter of fact, much of the external

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debt that this country has contracted over the decades has been very productive.

COMMISSIONER MACKINTOSH: One could add, Mr. Bell, that the more open and less closed an economy the more public debt assumes the characteristics of personal debt? If your economy is closed there is a much clearer distinction?

MR. BELL: Well, to the extent that your national debt -- or, to the extent that your internal spending is going outside of the country, I suppose is what you have in mind. As a matter of fact, it is much easier to do a lot of things with a more closed economy than with an open economy. There is no question about that. We are always faced in Canada with the problems with a more closed economy, such as the United States is not faced with, and this has to be taken into account in all of our calculations. There is no doubt about that.

COMMISSIONER MACKINTOSH: Yes. Economists have invented all sorts of policies for a closed policy but they have not been able to invent a closed economy.

COMMISSIONER BROWN: I would like to get clear one point, and that is, you apparently consider that a fixed exchange rate inhibits us from carrying out these policies, and the corollary of this is that these policies affect the fixed exchange rate problem, and you said this will effect capital movements in an unsatisfactory manner. Can you just give us your

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picture of where you think these pressures are going to come?

MR. BELL: Well, I would just like to amend your statement a little bit. I am not suggesting that it is impossible to carry out expansionary policies that we have advocated with a fixed exchange rate. What I am suggesting is that it is more difficult to do so; how much more difficult it is very difficult to conceive, but it is obviously going to be more difficult to carry out these policies with a fixed exchange rate. This is the reason, as a matter of fact, why we have taken such a fairly strong stand on this question of our foreign exchange rate. We do not want our foreign exchange rate to determine our internal or domestic policies. Some economists have put it, that in the situation we have now it is sort of the tail wagging the body of the dog. We are very much afraid, as a matter of fact, that we are going to stay in this sort of reverse position, and this is the whole nub of our problem.

COMMISSIONER BROWN: What I am trying to get at is, in which direction do you think the tail is going to wag the dog? In other words, where is the pressure coming?

MR. BELL: Where will the pressure come? I am afraid the pressure will come on our government to adopt more restrictive fiscal and monetary policies. As a matter of fact, this is what has already occurred as a result of that fixing of the exchange rate. I should not say as a result of fixing the exchange rate,

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but as a result, if I may be so blunt as to say, the government got itself into this exchange rate dilemma, because I am afraid that, again to be very blunt about it, I hold the government responsible for getting us into this position. I think this is really a self-engineered crisis, not something that came about naturally.

COMMISSIONER BROWN: Well, perhaps we can go on to some discussion in respect of monetary policy. You made quite a bit of the discriminatory effects of monetary policy.

MR. BELL: Yes.

COMMISSIONER BROWN: You mention three so affected, namely, public bodies, small businesses and prospective home builders. Perhaps you could tell us just how you think these are affected and to what extent.

MR. BELL: Yes. Whenever the Bank of Canada deems it necessary to pursue restrictive policies the elements in our society that suffer the most are the ones we have indicated here; the small business men is, as you know, to a very large extent dependent upon bank credits for his financing purposes, and the higher interest rates that result from a tighter monetary policy affect him, the municipalities and provincial governments. The smallest rise in interest rates results in a very considerable increase in the cost of borrowing for these particular agencies. Also, even a small rise in interest rates has very considerable effect on home owners, or prospective home

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owners and home builders who contract mortgage payments over a long period of years. Now, this is not so with respect to private corporations because, in the first place, private corporations are to a very large extent now capable of financing their needs through their internally generated funds; through depreciation allowances and undistributed profits, so the tight money policy has not nearly the same effect upon them.

Now, we have in mind here the period of 1955 to 1957 again when the Bank of Canada stepped in and attempted to bring about a restraint on inflationary pressures. The effect of that policy was not particularly significant as far as the private corporations were concerned, yet they were the ones that were largely responsible for generating these inflationary pressures. So the effect of the policy, and it was a very adverse effect, was felt by provincial governments, municipalities, small businesses and prospective home builders and so on.

COMMISSIONER BROWN: Well --

MR. BELL: Excuse me one second, sir. Consequently we felt that what is needed, and this may be very difficult, is that we should be inquiring into the use of a more selective kind of credit restraint or control. In other words, we felt that in dealing with a more specific kind of inflationary pressure the use of the central bank is a bit too blunt an instrument because it effects sectors of the economy that are not at all responsible for generating

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the inflationary pressures, and possible sectors that need to expand, as a matter of fact, without getting at this particular sector that is responsible for the inflationary pressures.

COMMISSIONER BROWN: Well, you have repeated the same general statements that are in your brief. What I was hoping for was something more specific. For instance, what evidence have you that small business was affected in a deleterious manner? Have you evidence of small businesses that had their lines of credit reduced and were not able to do the things that they wanted to do?

MR. BELL: This is quite evident. As a matter of fact, Mr. Gibson would be able to supply you with quite a lot of evidence of this.

COMMISSIONER GIBSON: I do not agree with you on that.

COMMISSIONER BROWN: All the evidence we have heard is to the opposite, or is not in line with your argument. I am asking you if you have any argument that supports this general statement? On the face of it it sounds like the logical sequence, but have you concrete evidence of the extent to which small businesses have been effected?

MR. BELL: Well, as a matter of fact, the size of bank loans which are published in the Bank of Canada summary of statistics would bear this out, I am pretty sure.

COMMISSIONER BROWN: Well, let's look at public bodies. We discussed this with public bodies

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MR. BELL: Here, of course, it is a different situation from small business. I am suggesting in the case of small businesses, because of their very heavy dependence on bank credit that a squeeze on the lending capacity of chartered banks affects them in so far as making available supplies are concerned, whereas as far as public bodies, provincial governments and municipalities are concerned, it is a different matter. Here it is a matter of interest rates going up and involves a considerable increase in their borrowing costs.

COMMISSIONER BROWN: This is the only effect in respect of them?

MR. BELL: This is the primary effect in respect of them. This is the primary effect as far as municipalities and provincial governments are concerned going into the capital market.

COMMISSIONER BROWN: They still make the same decisions, and that is what I want to make clear. I want to know what your information is.

MR. BELL: Yes.

COMMISSIONER BROWN: When you comment in respect of home builders are you concerned with the demand factor or the availability factor?

MR. BELL: It is a combination of the two of them as far as prospective home builders are concerned. They are certainly most definitely affected by any rise in interest rates. This is very, very obvious. If you have even an increase of one-half of

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one per cent, it is going to add up to a considerable sum over a long period of time. Also, the prospective home builders to the extent that they are dependent upon securing their loans from the chartered banks for home building purposes are affected by a reduction in funds available as well as by an increase in interest costs.

COMMISSIONER BROWN: Now, perhaps you would care to comment on the use of residential construction as a counter-cyclical element in the economy? You mentioned before that in the period you are talking about, 1955 to 1957, there was a period of full employment. Therefore perhaps it was a good thing that some of these other things were held down, otherwise we would have been in real trouble.

MR. BELL: Excuse me one second. When we discussed the period 1955 to 1957 and talked about full employment, of course, during part of 1955 we were still recovering from the recession that had started in the latter part of 1953, and there was still considerable unemployment, but certainly by the time we got into 1956 our unemployment rate had come down quite considerably.

COMMISSIONER BROWN: Well, you used the phrase "full employment" with reference to that period.

MR. BELL: Yes.

COMMISSIONER BROWN: About fifteen minutes ago and that is where I took it from.

MR. BELL: I just wanted to qualify that to

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COMMISSIONER BROWN: How about this question of residential construction as a counter-cyclical weapon?

MR. BELL: It has been used, as a matter of fact, over the years. It has been used to a certain extent as a counter-cyclical weapon. However, I am more concerned with developing housing and urban development, renewal and so on, along with the other projects that we have enumerated. We are more concerned with undertaking these on a larger scale for the purposes of bringing about full employment on a steady and regular basis. I do not think we should depend on residential construction -- housing construction -- and let it go, for example, until we get into a period of recession and then start building houses in order to get us out of that recession. We are concerned with social needs here and we do not believe that those social needs are simply to be put on the shelf and something done about them when the economy gets into a recession.

COMMISSIONER BROWN: Now, some of your recommendations with respect to direct controls were fiscal controls?

MR. BELL: That is right.

COMMISSIONER BROWN: Rather than monetary controls.

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this only amounts to the interest cost on the depreciation flow. How effective do you think this would be on corporation decisions?

MR. BELL: Well, this incidentally is not suggested here as the ultimate solution by any stretch of the imagination. What we are interested in doing is exploring ways and means, whether the variable depreciation rate be the best, or whether there be others for the purpose of regulating capital investment. In other words, so as to avert the kind of situation we got ourselves into from 1955 to 1957 where we did have over-expansion. Whether the variable depreciation rate is the best, or whether there are others that are better, we are not concerned with that, but what we are concerned with is that these areas be carefully looked into to find out what are the best or most feasible means of bringing about and regulating the flow of capital investments.

COMMISSIONER BROWN: The same reasoning applies to your suggestion in respect of the Capital Issues Committee.

MR. BELL: Precisely.

COMMISSIONER BROWN: Yes?

MR. BELL: It has worked, as a matter of fact, in a number of countries and it is in effect in a number of countries not only with respect to stock but also with respect to bank loans.

COMMISSIONER BROWN: I think I should say that we have heard that it is not working, so I am not sure there is not a certain amount of theory around

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MR. BELL: I know there is a conflict of opinion about this so far as it applies to an area like the United Kingdom.

COMMISSIONER BROWN: Instead of applying some of these specific controls how about the reverse? How about looking at it from the opposite end and removing some of the present controls? For example in house building, you mentioned the role of the banks as suppliers of N.H.A. funds when interest rates went up. What would your attitude be to the suggestion that the 6 per cent ceiling on bank charges might be removed?

MR. BELL: No, I personally cannot accept that because I believe, as we have pointed out here, that if anything, there needs to be a lowering of interest rates, not just to meet a particular situation, because I belong to that school of thought that thinks that the more and more our gross national product is devoted to developing things in the public sector, there should be lower interest rates. In other words, so that municipalities, provincial governments and the federal government as well can undertake to finance these things at a lower rate.

I think, as a matter of fact, with a lower rate of interest across the board, the present ceiling of 6 per cent on the banks would be perfectly valid. It would be more of a margin, as a matter of fact, between the present 6 per cent and the average interest

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rates now.

COMMISSIONER MACKINTOSH: Do you know of any other measure of adequacy in the economy that was established in 1933 or about then that still holds?

MR. BELL: Yes, the price of gold. Oh, it was established in 1935.

COMMISSIONER MACKINTOSH: You are a couple of years out.

MR. BELL: Yes, two years later.

COMMISSIONER MACKINTOSH: We have had representations that it is not adequate.

COMMISSIONER BROWN: Further on you suggest that the main element in a monetary policy is the cost of money. Now, what do you think the relative importance is between cost and availability?

MR. BELL: Excuse me. Where do we suggest that the main element is the cost of money?

COMMISSIONER BROWN: Well, let me see; perhaps my notes are wrong. I read it into your paragraph 82.

MR. BELL: No, here we are concerned with the issue of whether the central bank should play an active or passive role in the matter of influencing interest rates. We are taking objection really to the position taken by the former Governor of the Bank of Canada whom I believe appeared before you yesterday, when he indicated pretty clearly, as quoted in here, as believeing that the Bank of Canada should take a passive role, and that the Bank of Canada should not deliberately influence the movement

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of interest rates. It seems to me this is quite a strange theory to advance, because if the central bank cannot, or if the central bank does not assume the role of influencing interest rates then this denies to it one of the very important functions that a central bank should have in the national economy.

COMMISSIONER BROWN: Well, let us put it this way. Which do you think is the more important factor in the central banks operations in the monetary field, the availability of funds or the influencing of interest rates?

MR. BELL: Well, the two are interrelated, aren't they?

COMMISSIONER LEMAN: What is the interest rate at which public debt becomes non-self-liquidating?

MR. BELL: Becomes non-self-liquidating?

COMMISSIONER LEMAN: Yes.

MR. BELL: I must confess I have never heard it put this way before.

COMMISSIONER BROWN: Well, European countries have been expanding very much. They have done it in a period of very high interest rates. This has not inhibited their expansion.

MR. BELL: Yes. Of course, the reason that their interest rates are higher than ours is, I think, largely because of a more scarce source of capital available to them than is the case in North America. As a matter of fact, I am sure this is the reason.

COMMISSIONER LEMAN: Or is it perhaps because they are higher profit economies?

MR. BELL: Well, you have to specify which economies they are, because some of them may very well be and others certainly not.

COMMISSIONER BROWN: Perhaps we should ask you for a definition of what you consider to be a high profit economy?

MR. BELL: As a matter of fact, I would like to direct that question here.

COMMISSIONER BROWN: In paragraph 87 you refer to near banks?

MR. BELL: Yes.

COMMISSIONER BROWN: And I couldn't help but note one omission in your list, and I wondered why it was omitted?

MR. BELL: I assume that you are referring to credit unions?

COMMISSIONER BROWN: That is right.

MR. BELL: As a matter of fact, we didn't mean to enumerate all of the so-called near banks or financial intermediaries.

COMMISSIONER BROWN: At the moment they are a large element, larger than some of those which you mentioned and I wondered why they were omitted?

MR. BELL: We simply listed a few examples here. As far as the credit unions are concerned, you probably have already had representations made to you ---

COMMISSIONER BROWN: A great number.

COMMISSIONER [illegible] it perhaps [illegible] they are higher profit economies?

MR. BELL: [illegible] economies they are, because some of them may very well be and others certainly not.

COMMISSIONER BROWN: Perhaps we should ask you for a definition of what you consider to be a high profit [illegible]?

MR. BELL: As a matter of fact, I would like to direct that question here.

COMMISSIONER BROWN: In paragraph 87 you refer to near banks?

MR. BELL: Yes.

COMMISSIONER BROWN: And I couldn't help but note one omission in your list, and I wondered why it was omitted?

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MR. BELL: We simply listed a few examples here. As far as the credit unions are concerned, you probably have already had representations made to you ---

COMMISSIONER BROWN: A great number.

MR. BELL: ... by them. My understanding of the position that has been taken by some of them -- and this is indirect, I haven't heard the exact testimony that they offered to you -- but that is that if it is found that credit unions do have a considerable effect on monetary policy, then perhaps some ways and means might have to be devised to bring them under some regulation, but I think the point that they would make is that the kind of regulation or the kind of regulatory power imposed on credit unions might be very considerably different from other financial institutions because of the basic difference in their nature.

COMMISSIONER BROWN: I think you define their operations quite succinctly in paragraph 88; it seems to fit into your definition of the other near banks, but do I gather that you are not omitting them deliberately?

MR. BELL: No, most definitely not, no. As far as this whole question of the financial intermediaries is concerned, I think that here a very careful inquiry and study should be made to find out what are the suitable controls that would permit the monetary authorities to exercise the kind of influence over them as they now exercise over the chartered banks. This may be very difficult to work out controls on. I am not suggesting for one moment it is easy, but at the same time unless these intermediaries are brought under the control of the central bank -- and I say the central bank deliberately because

[illegible]

of the position that has been taken by some of them -- and this is indirect, I haven't heard the exact testimony that they offered to you -- but that is that if it is found that credit unions do have a considerable effect on monetary policy, then perhaps some ways and means might have to be devised to bring them under some regulation, but I think the point that they would make is that the kind of regulation or the kind of regulatory power imposed on credit unions might be very considerably different from other financial institutions because of the basic difference in their nature.

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I think it is more properly concerned with the central bank than any other institution -- then it seems to me that as these intermediaries grow and expand that it is going to be that much more difficult to implement monetary policy by the central bank authorities. I don't see why these intermediaries should be any more privileged than the chartered banks, for example.

I realize, of course, that there are very basic differences in the functions of the two, but at the same time the fact that they do exert considerable influence, I think, on prices and output, would suggest that they should be brought under regulatory control, as is and has been the case with the chartered banks for many years.

COMMISSIONER BROWN: In paragraph 84 you refer to the Bank of Canada maintaining low interest rates by supporting government bond prices, and you say that the inflationary effects could be avoided by changing the cash reserve requirements of the chartered banks?

MR. BELL: Yes.

COMMISSIONER BROWN: I can see that you could offset the multiplier effect of the cash reserves, but it would seem difficult to avoid at least the one for one increase in the money supply, and in any case I was wondering why you would choose that way of doing it rather than just a modest increase in the reserve, to have the same effect?

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MR. BELL: Well, if it was found desirable not to raise the cash reserves of the chartered banks -- which, of course, would be the effect of the Bank of Canada's open market operations -- then this method of varying the cash reserve requirements and raising the cash requirements of the chartered banks, which the Bank of Canada has the power to do but it has never exercised, could be used to neutralize the effect that open market operations would otherwise have on the cash reserves of the chartered banks.

This is only a suggestion because it may not be necessary; it may not be necessary or even desirable, as a matter of fact, to restrain an increase in the cash reserves in the chartered banks. It all depends on the economic circumstances that prevail at that particular time.

COMMISSIONER GIBSON: It could accomplish the same result by permitting an increase in the cash reserves in the banks of one-tenth or one-twelfth of the amount of the additional money that is required; this is the normal way.

MR. BELL: It is the normal way and if it could be accomplished that way, then all right, but there seems to be a good deal of apprehension in many quarters that by maintaining lower interest rates through open market operations that this would be inflationary.

Now, if it would be inflationary, then it seems that this particular method of varying the cash reserve requirements as now provided by the law

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Now, if it were to be inflationary, then it seems that this particular method of varying the cash reserve requirements as now provided by the law

might very well have a beneficial effect in restraining any undesirable increase in the cash reserves of the chartered banks.

COMMISSIONER GIBSON: But if you did it without increasing the cash reserves you would have an offsetting deflationary factor and you wouldn't do the job?

MR. BELL: Well, all we are suggesting here is that here is an available technique if circumstances warrant its use, and if it is not necessary for it to be used, then obviously there would be no point in using it.

COMMISSIONER BROWN: But if the central bank is going to buy some bonds, X number of bonds, is not the result going to be at least this amount of additional money in the system?

MR. BELL: If the Bank of Canada goes into the open market and buys government bonds, then the normal result is for an increase in the cash reserves of the chartered banks.

Now, if the Bank of Canada's purpose in going into the open market is simply to support government bond prices, but doesn't want the normal result of an increase in the cash reserves on the chartered banks, then it could to a certain extent prevent that increase simply by raising the reserve requirements of the chartered banks. Is that not right?

COMMISSIONER BROWN: You have a one for one increase.

COMMISSIONER GIBSON: That is technically so, but you still add the amount of the government

purchase of bonds to the money supply?

MR. BELL: But you would prevent the multiple effects.

COMMISSIONER BROWN: I don't understand that part in that paragraph where you refer to increasing these reserve requirements; I would have thought it would be the other way around?

MR. BELL: Which paragraph is that?

COMMISSIONER BROWN: It is in paragraph 85. At the moment the leverage is 12½ to one, and if you raise the requirement 10 per cent, then it is only 10 to one?

MR. BELL: I just don't see any point, as a matter of fact, in taking a ceiling of 12 per cent; I don't think that this is necessary at all. It is very important that there be a minimum reserve requirement which is fixed at 8 per cent, but for the purposes of putting a ceiling on this it just doesn't suggest to me that -- well, it doesn't suggest to me that there is any need for it.

COMMISSIONER BROWN: But it doesn't do any harm having it ?

MR. BELL: No, except that occasions might arise when it might be necessary to exceed the 12 per cent limit, and consequently I can't see that there should be any barrier put in the way of the Bank of Canada's operations.

COMMISSIONER BROWN: It was the use of the word "leverage" which I didn't understand. It seemed that the leverage got less.

MR. BELL: No, we don't mean it that way. Actually, "flexibility" is the word that should be used there.

COMMISSIONER MacKEEN: I just have a few questions, Mr. Chairman. First in regard to the recommended changes in the Bank of Canada Act, paragraph 113, and in the first recommendation you say, "and to promote full employment"; that is in the preamble.

Now, we have heard various experts from central banks, and some expressed one objective and some another, and they all mention the same purposes; full employment was one and in another case it might be the soundness of the currency and another one might be on exchange, and so on. What have you in mind that would reflect the objective of the bank to the substitution in the preamble?

MR. BELL: All we are suggesting here is that in the preamble to the Act that the words full employment should be inserted because they are not there now. In other words, the preamble sets up the objectives of national policy, and we simply think that full employment should be included as one of those objectives. In other words, we want to give emphasis to this point, and that is our reason for making this suggestion.

COMMISSIONER MacKEEN: On the second recommendation you mention three alternatives. What does the Congress consider the possible alternative there?

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COMMISSIONER MacKEEN: On the second recommendation you mention three alternatives. What does the Congress consider the possible alternative [illegible]

MR. BELL: Well, we haven't taken any position on this; we have simply suggested three possibilities for removing the governor or deputy governor, and the reason why we have done so is simply to avoid the kind of difficulties that were experienced about a little over a year ago when this unfortunate situation arose.

COMMISSIONER MacKEEN: The conditions under which they might be removed should be defined?

MR. BELL: Precisely, that is the main purpose; that whatever moving is considered to be best, that it should be carefully defined.

COMMISSIONER MacKEEN: You should have a fairly wide scope of authority?

MR. BELL: Definitely.

COMMISSIONER MacKEEN: Now, coming to the functions of the board of directors. What do you visualize is the proper function of the board of directors?

MR. BELL: Here we have in mind that because the Bank of Canada is an exceedingly important public institution that it should have -- and I am not for one moment casting any reflections on the present members of the board of directors at all -- but I think or we think that appointments to the board should consist of people who are highly qualified in monetary economics and should have considerable financial experience because the Bank of Canada or the central bank of our country is an exceedingly important one and therefore it should be staffed by only the most

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competent people available.

COMMISSIONER MacKEEN: I presume that the constitution of the present board is based to some extent on geographical selection and also that the selection is made with the broad business outlook available to management in Canada. Do you think it should be more on the basis of technical knowledge of monetary policies than anything else?

MR. BELL: I think that there should be more emphasis -- that is the word which I would like to use here -- I think there should be more emphasis given to appointing people who are highly qualified and competent in monetary economics which, of course, is what the Bank of Canada is all about.

COMMISSIONER MacKEEN: Do you see any possibility of a board largely composed of experts and they might disagree on policy matters and occasion some embarrassment to the Department of Finance?

MR. BELL: This is always quite possible, sir; it is quite possible, yes.

COMMISSIONER MacKEEN: Pardon?

MR. BELL: It is certainly quite possible. As long as human nature is involved there is always going to be a certain disagreement with respect to views, but we feel that the composition of the board should lean more in the direction of expertise; the highly complex and intricate problems that the Bank of Canada and the central bank has to face would seem to warrant that conclusion.

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COMMISSIONER MacKEEN: From what fields

would you choose such people?

MR. BELL: Well, one of the obvious ones, of course, would be highly competent economists, particularly those with special training in monetary economics. I am not suggesting for one moment that the entire board consist of professorial types, but only those in a particular field.

COMMISSIONER MacKEEN: If you arrive at that solution you may get an even greater degree of diversion.

MR. BELL: No, all I am suggesting or all that we are suggesting here is that there should be a bit more emphasis given to the expertise side; that these very intricate problems facing the central bank really require that.

COMMISSIONER MacKEEN: Thank you very much.

COMMISSIONER HARROLD: I have just one or two questions on this section, Mr. Chairman, and this has to do with your fourth recommendation where you say that the Act should provide that the final responsibility for monetary policy clearly rests with the Minister of Finance. Do you see any difficulty about this interference that you mention in the way that you do when you say that it is hardly necessary to ask that the Congress does not want to see the Bank become a department of government. Have you any suggestions as to how safeguards may be written into the Act to see that this doesn't happen?

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MR. BELL: I would think this would be very, very difficult to do. The reason we make this point here, again, is to try to avert a repetition of the situation that has taken place. We have had two M'nisters of Finance now who have attempted to disclaim responsibility for monetary policy, and in our view this just does not make sense. The Minister of Finance has to accept ultimate responsibility for monetary policy, the same as he accepts, or he and his government accept, ultimate responsiblity for fiscal policy. If the Minister of Finance attempts to shove off the responsibility to the Governor of the Bank of Canada for any monetary policy, as the recent Ministers of Finance attempted to do , then the Minister of Finance is actually saying that public policy carried out by the Bank of Canada is the sole responsiblity of the Bank of Canada and not the responsibility of the elected representatives in Parliament.

This is certainly a most undemocratic thesis to lay down, in my opinion. Furthermore, from a purely practical point of view it is just unworkable, for fiscal policy and monetary policy must work in harmony, and if the Minister of Finance is going one way and the Governor of the Bank of Canada is going another way, then obviously the system is just going to break down. Fiscal policy will be thwarted, as it has been when a monetary policy is carried out in another direction.

COMMISSIONER HARROLD: You do not see, then,

any difficulty in arriving at a balance be how independent the Bank should be or whether should not be independent and directly responsible to the Minister?

MR. BELL: I do not believe there is any particular difficulty and I do not think, as a matter of fact, these things should be spelled out. I think you would really create difficulties if you attempted to spell out in a detailed way the exact responsibilities of the Governor of the Bank of Canada in relation to the Minister of Finance. After all, we had in this country, I think for many years, a pretty close co-operation between the Bank of Canada and the government. Events seemed to go along pretty smoothly, unless, of course, there were certain things going on behind the scenes which I was not aware of. That may have been so, but I do not think so. Again I think this is a matter of developing through pragmatic experience a working relationship between the central bank on the one hand and the government on the other. But when all is said and done, only the government can accept ultimate responsibility for the monetary policy, for only the government is an elected body. The Governor of the Bank of Canada is not an elected official.

COMMISSIONER HARROLD: Have you given any thought to a system of directives, which is permissible under the British system? Do you think it would serve any useful purpose here? In other words, if a difference of opinion should arise between the Minister of

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COMMISSIONER HARROLD: Have you given any thought to a system of directives, which is permissible under the British system? Do you think it would serve any useful purpose here? In other words, if a difference of opinion should arise between the Minister of

Finance and the Governor of the Bank of Canada, do you think it would be a good thing to have a system of directives by which the Minister of Finance could either publicly or otherwise direct the Governor of the Bank to do certain things in the way of a monetary policy?

MR. BELL: I am going to refer to what a former Governor of the Bank of Canada had to say on this matter. This was before the House of Commons Standing Committee on Banking and Commerce during the decennial revision of the Bank of Canada Act in 1954. The then Governor of the Bank of Canada, Mr. Towers, was asked what would happen in the event of a conflict between himself and the Minister of Finance. His answer was quite forthright and very acceptable. He said that in the event of a conflict between himself and the Minister of Finance, or the government, on policy, either he would have to reconcile to their policy or he would have no alternative but to resign. If the Governor cannot carry out government policy, then I think he simply has to resign because after all he is not ultimately responsible for government policy; only the government can be.

COMMISSIONER HARROLD: There is just one more question, and that has to do with the suggestion that the Bank of Canada Act should itself provide a periodic and more frequent revision of the Bank of Canada Act.

If there is felt a great need for this, there is nothing in the present Act which prohibits

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amendments being made at any time that it may seem necessary to have them made. But do you think that a periodic revision of this kind would be more acceptable or provide a more definite benefit than the present system in which an amendment can be brought in, I presume, at any session of Parliament?

MR. BELL: Here we have in mind the very speed at which events take place now and the consequent need for reviewing matters at more frequent intervals. As a matter of fact, we think such things as the decennial revision of the Bank of Canada Act, and Royal Commissions such as yours, besides serving the purpose of making recommendations with respect to policy, serve an extremely important function in providing public education and promoting public education on this most important and, at the same time, difficult field. Consequently, the more airings of these matters there are, the better informed the Canadian public is likely to become.

Therefore, these things serve more than just the purpose of bringing about necessary revisions in Acts, or in having policy recommendations made. They also serve the extremely important function of education.

COMMISSIONER HARROLD: You suggest something less than 10 years. Can you be more specific? Would you suggest 5 years, 6 years?

MR. BELL: I do not think it is very important to specify it here, but I think that it should be less than every ten years. Ten years is far too long

now. Too many things take place in a period of a decade. Every five years might be quite feasible, but certainly something less than ten years.

COMMISSIONER LEMAN: Not with a Royal Commission every five years?

MR. BELL: No.

THE CHAIRMAN: Thank you very much, gentlemen, for a very useful discussion. I hope we have not exhausted you, Mr. Bell. You have answered the questions in great detail and in a most helpful way. We appreciate very much you presenting your brief and being with us today. I can only say that we are extremely gratified at the views we have obtained from you this morning.

MR. MacDONALD: My Lord Chief Justice, and gentlemen, on behalf of the Congress I want to express our appreciation of the courtesy and attentive hearing you have given us. We have been very favourably impressed with the penetrating and pertinent questions that have gone on, and we trust that the amplification of our submission which has resulted will be reflected in your eventual report.

THE CHAIRMAN: We shall adjourn now until 9.15 tomorrow morning when we shall hear submissions from the Canadian Association of Consumers, the Canadian Exporters' Association, and Professor E.T. Neufeld.

--- Adjournment.

Royal Commission
on
Banking and Finance

THE CANADIAN LABOUR CONGRESS

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THE SUBMISSION OF

THE CANADIAN LABOUR CONGRESS

TO THE

ROYAL COMMISSION ON BANKING AND FINANCE

1962

SUMMARY

(The Canadian Labour Congress, the main Canadian central labour organization, with a membership of over 1,000,000 is located at 100 Argyle Avenue, Ottawa, Ontario.)

1. Monetary and fiscal policies, properly co-ordinated, can play a dynamic role in promoting full employment and adequate economic growth.

2. While monetary policy by itself is limited in what it can achieve, non-monetary measures for stimulating economic growth will usually be dependent on, often impossible without, an appropriate expansion of the money supply. Monetary policy and fiscal policy must supplement each other.

3. Neither private capital investment nor exports can be relied upon to restore full employment and the pre-1957 economic growth rate.

4. The slow-down of our economy can be corrected only by appropriate fiscal and monetary policies. What is required is a massive expansion in the public sector of the economy, which, by comparison with the private sector, has been seriously neglected. By the "public sector" we mean goods and services which governments (national, provincial and municipal) invest in: slum clearance and urban redevelopment, public development and conservation of resources, housing, hospitals, schools, provincial universities, technological and scientific institutions, roads and many other things essential to

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any advanced society.

5. "Expansion in the public sector", does not mean makeshift public works programmes, but a planned, long-term, sustained expansion of social capital, public services, and investment in the most important capital of all, human capital. Meeting these needs would at the same time go a long way towards solving our employment problem.

6. Investment in the public sector provides an important stimulus to the private sector through the multiplier effect. Consequently, the initial public investment not only increases demand for goods and services to satisfy social needs, but also, indirectly, for goods and services to satisfy individual consumer needs. Business investment is thus stimulated by individual and collective demands.

7. This is not possible without effective co-ordination between monetary and fiscal policies. At present, with unused economic capacity, a carefully planned deficit budget will be required, supported by an appropriate expansion of the money supply.

8. In an economy with unused resources, borrowing by expanding credit is not inflationary. The new credit would be employed to put such idle resources to work. The increase in purchasing power would be offset by a real increase in the gross national product. Inflation will result only if deficit financing is continued after full employment has been achieved. (Some may object that such policies are inappropriate in view of the recent changes in exchange rate policy. See below.)

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5. "Expansion in the public sector", does not mean makeshift public works programmes, but a planned, long-term, sustained expansion of social capital, public services, and investment in the most important capital of all, human capital. Meeting these needs would at the same time go a long way towards solving our employment problem.

6. Investment in the public sector provides an important stimulus to the private sector through the multiplier effect. Consequently, the initial public investment not only increases demand for goods and services to satisfy social needs, but also, indirectly, for goods and services to satisfy individual consumer needs. Business investment is thus stimulated by individual and collective demands.

7. This is not possible without effective co-ordination between monetary and fiscal policies. At present, with unused economic capacity, a carefully plan deficit budget will be required, supported by an appropr expansion of the money supply.

8. In an economy with unused resources, borrowin by expanding credit is not inflationary. The new credit would be employed to put such idle resources to work. The increase in purchasing power would be offset by a real increase in the gross national product. Inflation will result only if deficit financing is continued after full employment has been achieved. (Some may object that such policies are inappropriate in view of th recent changes in exchange rate policy. See below.)

9. In the past there has been too much reliance on general monetary controls to combat inflationary pressures which did not result from excessive general demand. The Bank of Canada has, for example, applied a tight money policy to curb inflationary pressures brought on by excessive private capital spending. The effect on such spending is negligible because corporations depend largely on internally generated funds for capital investment. But tight money and high interest rates have substantial adverse effects on provincial and municipal governments, and other public bodies which raise loans in the capital market; smaller business, which must invariably rely mostly on bank credit; and homebuilders for whom even a small increase in mortgage rates means an appreciable addition to costs.

10. The answer to specific inflationary pressures is selective, not general, monetary controls. One selective control with distinct possibilities for regulating corporate spendings is a variable depreciation rate. Another is the licensing of large capital issues.

11. The Bank of Canada should assume an active role with respect to interest rates. A central bank which does not accept the responsibility of positive guidance and influence on the level of interest rates is failing to fulfil one of its primary functions, the regulation of the cost of money in accordance with economic requirements.

12. A fixed Bank Rate would usefully supplement open market operations by indicating the kind of monetary

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policy the Bank believed appropriate.

13. A major weakness in our financial system is the fact that financial intermediaries such as instalment finance companies, personal loan companies, trust and loan companies and others, are not subject to any kind of monetary control. Unless some control over these institutions is co-ordinated with control over the banking system, monetary policy will become increasingly less effective.

14. Recent changes in exchange rate policy have particular significance for monetary policy. We are especially apprehensive that a fixed exchange rate will make it difficult for Canada to pursue expansionary monetary and fiscal policies necessary to achieve full employment and suitable economic growth rates.

15. For Canada, with its comparatively large external transactions, a free exchange rate is preferable. It helps adjust our balance of international payments to meet our domestic needs. With a fixed exchange rate, domestic policies which may actually promote unemployment and low growth rates may be adopted because they are considered essential to balance of payments requirements.

16. The present balance of payments problem really underlines the need for a free exchange rate. With a free rate, and positive policies to stimulate exports of goods and services, our present external difficulties could be greatly reduced and there would be no need to employ either long-term external or internal restrictive policies.

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to compensate for recurring deficits on "invisibles". Careful consideration should be given to measures to boost merchandise exports, e.g., export subsidies, further improvement in export credit facilities, and tax incentives to firms which exceed certain export quotas.

18. There may also have to be important changes in the structure of some secondary industries, where there are too many firms operating in a comparatively small market, which only results in unnecessary inefficiencies.

19. The tourist industry could be improved to attract foreign tourists to Canada and to encourage Canadian tourists to do more of their travelling inside Cana

20. But even with such measures, we still doubt whether, with a fixed exchange rate, Canada can avoid serious balance of payments problems in the future. The best policy for Canada is to get back to a floating rate. The next best is to get the International Monetary Fund rules changed to allow the rates to fluctuate within appreciably wider limits. But if we can neither get back to a floating rate, nor get a more flexible fixed rate, then we must press hard for new international monetary arrangements which will provide for far greater international liquidity.

21. Canada alone cannot change the present inadequate international liquidity arrangements. But, if you feel unable to recommend either outright return to a floating rate, or a more flexible fixed rate, then it becomes imperative for you to consider carefully what policy Canada should adopt towards the various plans for greater international liquidity, and to make recommendations

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22. The following changes should be made in the Bank of Canada Act:

(a) The preamble should be amended by inserting, after the words "prices and employment" in the sixth line, the words, "and to promote full employment".

(b) Section 6 (3) (a) should be amended to make clear the precise procedure to be followed in removing the Governor or Deputy Governor. If it is considered necessary to place the Governor and Deputy Governor beyond the reach of dismissal by the Government, the paragraph should be amended by adding the words, "but may be removed from office at any time by the Governor General, on Address of the Senate and House of Commons." If it is felt that the Governor and Deputy Governor should not be placed in so independent a position, then the paragraph might be amended by adding the words, "but may be removed for cause at any time by the Governor in Council", or "may be removed by the Governor in Council for misbehaviour or incapacity, inability or failure to perform his duties properly".

(c) Steps should be taken to make the Board of Directors really effective, which it does not appear to be now. This may not require any amendment, (though we think it should be specified that a due proportion of the Directors should be people of financial

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(d) The Act should distinctly provide that final responsibility for monetary policy rests with the Minister of Finance.

(e) The Auditor-General should be designated as the Bank's auditor.

(f) The Bank of Canada Act should itself provide for periodic, and fairly frequent, revision.

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My Lord Chief Justice and Members of the Commission:

1. The Canadian Labour Congress, which was one of the bodies asking for the appointment of this Commission, welcomes the opportunity to appear before you and to present its views. The operations of monetary and financial institutions have an important bearing on two matters which greatly concern the labour movement, namely, employment and economic growth (with reasonable price stability).

2. During the past five years Canada has experienced high rates of unemployment and low rates of economic growth. Furthermore, there does not appear to be any prospect of more than a temporary improvement in this situation. It is fitting, therefore, that an inquiry of this kind be undertaken to see how financial and monetary policies can best contribute to reversing these economic trends. Monetary policy cannot, of course, be considered adequately apart from fiscal and other policies and we shall, therefore, have something to say about the latter as well.

3. You have been appointed to "enquire into and report upon the structure and methods of operation of the Canadian financial system, including the banking and monetary system and the institutions and processes involved in the flow of funds through the capital market", and to "make recommendations (i) for the improvement of the structure and operations of the financial system and, more particularly, (ii) concerning the Bank Act, the Bank of Canada Act, the Quebec Savings Banks Act, and other relevant federal legislation".

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4. The Congress will have nothing to say about the Bank Act or the Quebec Savings Bank Act, nor, except incidentally, about the operations of the chartered banks and the Quebec Savings Banks. It will confine its presentation to the broad, general questions before you, and to certain suggestions for amendments to the Bank of Canada Act.

5. You have indicated that you would like the Congress to provide information on "the activities of unions as borrowers and lenders in the capital market; the reasons for which unions borrow and the sources of funds open to them; the forms in which unions invest funds which they have accumulated; the ways in which borrowing and investment policy is influenced by credit conditions."

6. Answers to these questions can be almost as brief as the famous chapter on the snakes in Ireland.

7. The Congress has almost no information on the subject, and no means of getting it except by sending out questionnaires to its hundred or so affiliated unions, a process which would involve the small staff of the Research Department in an almost infinite series of follow-up letters and an appallingly time-consuming analysis of such information, probably meagre, as might be received. Anything like full information on the subject will become available only with the publication of the statistics to be provided by corporations and unions under the Act of last session.

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9. You have also indicated that you would like the Congress to provide "information on pension and welfare plans operated for union members; the growth of such funds and probable future trends; a description of the various arrangements for the management of such funds and the location of investment responsibility; changes in this regard and the reason for such changes; the rates of increase in the size of the various types of fund and the

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12. Most pension and welfare plans for union members arise out of collective bargaining. The Congress has about 3,500 collective agreements on file, but the kind of analysis of them which you would like is altogether beyond the resources of the Research Department, and even it it were not, the coverage is so spotty that any results would be of very dubious value. The Dominion Department of Labour may be in a position to give pretty full information on the subject. Its files are much more complete, and its staff very considerably larger, to put it mildly.

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Annuities, or insurance company funds. The Dominion Government Annuities are, of course, managed by the Annuities Branch of the Department of Labour, the insurance funds by the insurance companies concerned. Sometimes the employer pays the whole cost, sometimes the employees contribute. With the Annuities Branch, only the employer can contract; but with the insurance companies joint employer-union contracts are possible, and in fact often exist.

14. The safety of pension fund investments is presumably adequately provided for by the Annuities Act and the various Insurance Acts. So is the soundness of administration. The adequacy of the pensions themselves, with the related questions of vesting and portability, is, of course, another matter, but one which is beyond your terms of reference.

15. Welfare plans under collective agreements are exceedingly numerous and varied. Most collective agreements in Canada (there are about 6,000 of them) are between a local union and a single plant, though there are, of course, important agreements between a group of locals and a group of employers, or between a national or international union and a multi-plant company, or between a group of unions and one or more large, national employers. By no means all of the 6,000 agreements provide for welfare plans of any kind; but a great many do. In some, the employer pays all the cost; in some, employer and employees both contribute. In some, there is a special fund established, administered either by the employer or by the employer and the union jointly; in some, the whole thing is handed over

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18. We wish to make it clear at the outset that we believe that fiscal and monetary policies should play a <u>dynamic</u> role in promoting objectives of full employment and suitable economic growth. The national budget, supported by an appropriate monetary policy, can be a powerful instrument in attaining and maintaining these national purposes.

19. The Congress has repeatedly urged that expansionary public policies are required to deal with the slow-down of our economy. This does not mean reliance on monetary policy alone. Far from it. Monetary policy by <u>itself</u> is limited in what it can achieve.

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21. While the volume of credit, and its satisfactory regulation by the Bank of Canada, are highly important in influencing demand in the economy, they are certainly not the only factors. An expansion of credit will not bring about full employment and suitable economic growth unless there is demand for the expanded credit. The depression years of the 1930's proved this beyond doubt, if it ever needed proving. An abundant supply of cheap money will obviously not encourage business to borrow if the latter cannot profitably employ additional funds.

22. But at the same time, non-monetary measures for stimulating economic growth will usually be dependent on, often impossible without, an appropriate expansion of the money supply. It is the volume of money supply together with the velocity of its circulation, or the rate at which the money supply is used, which determines the level of output in the economy. Those who question the value of monetary policy in lifting an economy from its depression are thinking in terms of monetary policy only. The correct approach is to regard monetary policy and fiscal policy as indispensable supplements to each other.

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24. Annual investment in the private sector of the economy has been, and still is, considerably below the post-war peak investment of 1957. This is understandable, because ever since the private capital investment boom of 1955-1957, productive capacity has exceeded effective demand.

25. There are those who contend that all that is required to stimulate economic activity is to reduce the "high" corporate income tax. With so much unused industrial capacity, we find it difficult to accept the theory that corporate tax rates are primarily responsible for our inadequate econonic growth. Exponents of this theory argue that "high taxes" are "drying up" private capital funds, and stifling incentives to private investment. Thus their solution to the problem of inadequate growth is to reduce the corporate tax rate. This, they argue, would increase the availability of private capital and make investments more profitable, which would stimulate investment and hence economic growth.

26. But as long as productive capacity exceeds effective demand, there can be no incentive for businessmen to invest for the purpose of creating more unused capacity. Generous depreciation allowances, which are the envy of U.S. businessmen, provide ample means for the replacement of worn out or obsolescent equipment. It should be remembered that the "high" corporate tax rate did not prevent corporations from investing excessively in the 1955-1957 period. Business investment reached an all-time high then because corporations believed (erroneously,

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> " The two most recent policy measures to improve the situation (unemployment in the U.S.): permission of faster depreciation and a tax allowance for new equipment, seem sensible measures in themselves, but hardly to have a bearing on the main problem.
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> Both measures aim at the same target: stimulation of industrial investment. Within limits sufficiently narrow, there would be nothing unsound with such an idea. But under present conditions in the United States the consequences must be increased unemployment.
>
> There are expansionary forces at work in the American economy, but they are mostly directed 'inward,' i.e., toward increased efficiency. The autonomous purpose of the economic system of capitalism is not maximum output but maximum productivity, as every economist knows, althouth this is sometimes forgotten.
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> Both measures aim at the same target: stimulation of industrial investment. Within limits sufficiently narrow, there would be nothing unsound with such an idea. But under present conditions in the United States the consequences must be increased unemployment.
>
> There are expansionary forces at work in the American economy, but they are mostly directed 'inward,' i.e., toward increased efficiency. The autonomous purpose of the economic system of capitalism is not maximum output but maximum productivity, as every economist knows, although this is sometimes forgotten.
>
> The tax allowance will tend to increase

" the after-tax income of firms. There is very little likelihood that in the present situation this would appreciably affect their spending.

Except for President Kennedy, and perhaps some of his advisers, those in authority seem unwilling to face the hard fact that there is no substitute for effective demand. And back of effective demand stand the consumers with their private needs and their various government organs with their collective needs.

In my view, the stress is much too much on stimulation of demand through stimulation of investment in industrial facilities, too little on 'investment' in human beings and socially important projects. Industrial Investment is a healthy thing only as long as it reflects effective demand and is not merely a response to artificial stimulants (underscoring ours). The overstressing of the importance of industrial investment is probably due to some of Keynes' misconceptions about the role of investment in the economic process" (New York Times, June 3, 1962, p.12E).

28. For much the same reasons, the acute deficiency in total demand for goods and services in Canada cannot be corrected at the present time by relying on private investment. Nor can it be corrected by relying on exports. (Exports last year were at an all-time high, with a small surplus over imports.) It can be corrected only by the

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application of appropriate fiscal and monetary policies. How? Demand can be increased either through personal income tax custs, or through increased public investment. Either would result in unbalancing the budget. The object would be to allow the budget to remain unbalanced until idle resources were fully employed. Personal income tax cuts alone would probably not be sufficient to raise, and sustain, demand to the degree necessary to attain full employment and a relatively high degree of economic growth. There is no question that adequate public investment could attain these objectives.

29. The Congress has advocated a massive expansion in the public sector of the economy, which, by comparison with the private sector, has been seriously neglected. By the "public sector" we of course mean goods and services which governments (national, provincial and municipal) invest in: slum clearance and urban redevelopment, public development and conservation of resources, housing, hospitals, schools, provincial universities, technological and scientific institutions, roads, parks, and many other things highly essential to any advanced society.

30. When we speak of "expansion in the public sector", we are thus not speaking of makeshift public works programmes, of the kind which were hastily contrived to meet mass unemployment in certain countries in the 1930's. What we are proposing is a planned, long-term, sustained expansion of our social capital, of our public services, and of investment in the development of the most important capital of all, our human capital. Meeting

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these important needs would at the same time go a long way towards solving our unemployment problem.

31. Investment in the public sector provides, of course, an important stimulus to the private sector through the effect of the multiplier. Consequently, the initial public investment not only increases the demand for goods and services to satisfy social needs, but also indirectly increases demand for goods and services to satisfy individual consumer needs. Business investment is thus stimulated by individual and collective demands. The result is a large and sustained increase in total demand.

32. Such a programme is not possible, however, unless there is effective co-ordination between fiscal and monetary policies. At a time when there is unused economic capacity, i.e., idle workers and surplus plant, a carefully planned deficit budget will be required. How should the deficit be financed? There are some who would support a deficit policy but only if such a deficit could be financed without expanding credit, i.e., by borrowing from the non-banking public. This is another doctrinaire view which under certain circumstances is not at all practicable. If government borrowing for the purpose of financing the expansion of the public sector of the economy simply replaces spending in the private sector of the economy, total demand will of course remain unaltered. After exercising the best possible judgment, the public authorities must decide how much can be borrowed from the non-banking public without denying the private sector funds which otherwise would

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be spent there (obviously not an easy judgment to make), and how much must be borrowed from the banking system. An appropriate expansion of the cash reserves of the chartered banks will then be required to enable the latter to make the necessary credit available to the government. This, of course, cannot be done unless the central bank agrees to pursue an appropriate policy of open market operations.

33. Those who object to such a policy base their opposition largely on the ground that this would lead to inflation. It is important to examine this argument, because it constitutes the primary objection of most opponents to an unbalanced budget which must be financed in whole or in part, by an expansion of credit. Indeed, there are many who take for granted that financing government deficits by expanding credit will <u>always</u> cause inflation. Modern economic theory does not support such an assumption, and furthermore, it has been demonstrated time and again to be patently false in practice. In an economy that is not fully employed, an economy with idle manpower, unused plant capacity and idle resources, borrowing by expanding credit is not inflationary. Why? Because new credit would put these idle resources to work. The increase in purchasing power would be offset by a <u>real</u> increase in the gross national product. In other words, while additional money creates additional demand for goods and services, idle resources can be used to satisfy this additional demand. Hence, there is not likely to be any significant pressure on prices.

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34. This is entirely different from the situation of a fully employed economy, where financing a deficit by expanding credit would only result in the creation of an additional demand for goods and services which, in the absence of idle resources, could not be produced until new resources became available. Thus, in this kind of situation, more money just causes buyers to bid against one another for a virtually fixed supply of goods and services. Prices, under these circumstances, can only go up.

35. The failure to distinguish between these two very different things leads to a false conception of the effects of "deficit financing" on the national economy.

36. Those who reject the idea of expansionary public policies are the victims of what has been aptly called "inflation psychosis". These people continued to have an obsession about inflation long after the signs became clear that those inflationary pressures which a central bank could help restrain had given way to inadequate growth and unemployment.

37. For some strange reason, the myth still persists in North America that unbalanced budgets will give rise to inflation under any and all economic circumstances. The fact that this has been disproved in practice so many times does not seem to have done much to dispel the myth For example, during the past four years overall price increases have been negligible in Canada, although during each of these years we incurred budget deficits. Indeed, between April 1, 1958 and April 1, 1959, the budget deficit came to the substantial sum of $609 million. According

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38. The situation was similar in the United States. For example, between June 30,1958 and June 30, 1959, the United States experienced a sizable deficit of $12.43 billion. Again, according to the North American mythology, the U.S. should have been swimming in inflation. Instead, however, both consumer and wholesale prices rose by less than 1 per cent.

39. These, incidentally, were the years when "inflation psychosis" was especially rampant in financial and business circles in both countries. The dire predictions about runaway inflation led to the usual outcries that we must have balanced budgets. Had government officials been foolish enough to reduce government expenditures to bring them into line with lagging revenues, the recession of 1958 would simply have worsened and lasted even longer.

40. The criticism which we have to offer with regard to the budget deficits of the lst five years is that they were a significant degree involuntary. They resulted, at least at the beginning, because the slow pace of economic activity yielded less revenues than were required to balance expenditures. What was needed, right at the beginning of the slow-down of our economy, was deficits systematically planned for the purpose of

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expanding national income and bringing about full employment. We shall have more to say about this farther on.

41. In both Canada and the United States, there are still many influential elements who regard a balanced budget (or even a budget surplus to retire the public debt) as an economic necessity even when the overall performance of the economy is inadequate to sustain full employment and adequate growth. The Congress, in its annual submissions to the Government of Canada, the Senate Committee on Manpower and Employment and the Prime Minister's Conference on Unemployment, has repeatedly stated its opposition to such views. Indeed, we believe that the prevalence of these views has contributed significantly to the inadequate performance of our economy during the past few years.

42. It would seem that the Congress is not alone in challenging such views. American government officials, including President Kennedy, are now reported to be interested in the different approach of European governments to the use of national budgets to foster economic growth. U.S. News & World Report (June 11, 1962) in an article entitled "Kennedy Takes a Look at Europe's Budgets", states:

> " Two things about Western Europe appear at this time to hold a deep interest for President Kennedy.
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43. That European officials believe these two things to be closely related is borne out in a recent article in the New York Times (May 13, 1962, p. 24) which reports that the contrast between Western Europe in recent years, with its "remarkably successful economic performance" and the United States, "with chronic unemployment and slow growth" has "prompted a profound examination on both sides of the Atlantic" by Government officials, economists and others. The writer reports that while few observers attribute the difference in economic performances to any one cause, the one cause which is receiving the heaviest stress in analyses "is the contrast between American and European financial policies: government budget policy (spending and taxation) and monetary policy". The writer states:

> "In the United States the financial actions of the Government, for varying reasons, have normally been designed to check demand -- mainly through budget decisions aimed at a surplus and frequent use of 'tight money'.
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> Budget deficits have often occurred, despite original decisions aiming at a surplus, because tax receipts failed to come up to expectations as the economy lagged. But, according to most current analyses, this has not altered the restrictive effects of the original decisions.
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(France had budget deficits throughout the 1950's, including 1960; the United Kingdom had deficits in every year from 1951 through 1961; in four of the last five years, 1957-1961 inclusive, West Germany has incurred deficits; Italy had deficits from 1950 to 1961, inclusive, with the exception of one year. Source: International Financial Statistics).

44. An economist is quoted as saying:

" The rule in Europe has been never to restrict demand by budget surpluses or tight money unless the economy reached the stage of being badly overheated, with a serious labour shortage and full-capacity operation by business. Even then, the restrictive policy has been maintained for as brief a period as possible. This is true of all countries.

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This fundamental difference has been at work since the middle of the last decade. In my opinion and that of many others, it accounts for most of the difference in economic performance on the two sides."

A Government official is reported as expressing "a common viewpoint":

" Quite frankly, I fear you will continue to do rather badly in the United States until you become more modern in the matter of the Federal budget and its use as an economic weapon. We have all learned the lesson in Europe some years ago. You never hear anyone talking about the 'national debt', for example. We approve of deficits, and they don't have to be inflationary.

If your Government had aimed at one or two sizable deficits at the right times over the past six years, instead of always trying to balance the budget and getting deficits by mistake, I will warrant you there wouldn't be half as many people out of work in West Virginia today. We have coal troubles, too, but we have no unemployment."

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Demand is natural. It has risen here without interruption because our Governments helped it to do so."

The writer reports that:

"Western European Governments have averted budget surpluses mainly by compensating for a rapid rise in tax revenues. The compensation has been a rapid rise in spending -- on schools, roads, agriculture, civil service pay and other things."

46. We have reported these comments because to a large extent they also apply to Canada. We should like to quote also a Canadian observer, Dr. Robert M. MacIntosh, Supervisor of Investments of the Bank of Nova Scotia. Speaking to an Ontario Federation of Labour Study Conference on Unemployment, on February 10, 1961, on "The Black and White of Deficit Finance", he said:

"... There is in this country and in the United States and in most Western countries a fear of Federal deficits which is deep-seated. It is to a very considerable extent

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"irrational, but it nevertheless exists. Now why does it exist? I think perhaps the first reason is that traditionally a Federal deficit has been associated with the idea of a dead-weight debt, and most people who borrow, who create assets, who build factories or equipment or schools or roads or hospitals, are able to see the physical consequence of their borrowing. In the case of the Federal Government, this is true only to a lesser degree; most of the Federal debt arose, of course, out of the war . . . . The assets which were on the other side cannot be measured or seen, although of course they are none the less valuable for that. In fact, to a degree, our national freedom is the asset on the other side, but you can't find it in a balance sheet. So for this reason people are generally inclined to regard a Federal deficit as a bad thing, and undesirable.

Now more specifically under conditions in the last few years in which to some extent we have pursued counter-cyclical fiscal policy, large deficits have come (in the minds of a large part of the public) to mean either inflation or high interest rates or both. Why should high interest rates result from large deficits? They need not result of course, but . . . . what I want to emphasize is the extent to which they are associated

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"in the general concept of Federal finance. If one increases the supply of bonds offered by the Federal Government substantially, unless there is some off-setting factor to increase the demand, then of course as in the case of any other commodity, where you increase the supply very greatly you will drive down the price, that is the price of bonds, and drive up interest rates; and by and large this is the process which we have been going through periodically in recent years.

Now the people who are responsible, as I am, for large sums of money, which is primarily invested in bonds, and very frequently in government bonds, that is the insurance companies and the banks, the trust companies, individuals as well across the country, have come to fear that an increasing supply of bonds arising out of deficit finance would force interest rates higher. Therefore, in order to avoid the depressing effects which this would have upon their existing holdings, people hold back. They won't go far out into long term bonds; they are reluctant to do so, and the net effect is that it becomes increasingly difficult for the Minister of Finance to sell more bonds. The more he sells, the more this psychological reaction takes place.

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" Now this need not occur. If monetary policy is conducted in such a way in conjunction with fiscal policy, that is, with a Federal deficit which increases the money supply, then interest rates can be reduced during periods when the debt is rising. This, however, in recent years has raised a further psychological problem in the financial market, in that people have come to fear inflation. This fear is so widespread that it now extends far beyond the financial community to the thinking of the broad mass of the Canadian people or to very many of them at any rate. And since they fear that a Federal deficit will mean either high interest rates if the money supply is not increased, or inflation; and that inflation will eventually reduce the value of their assets, then both these reasons cause them to withdraw their buying power from the bond market and switch to a greater degree to other forms of asset, such as stocks and real estate. And, of course, this process has been troublesome in recent years.

Now, as I say, these fears are not wholly rational by any means. Nevertheless they exist, and they do have to be combatted. The moral of the story is that there is a need for a positive approach to a fiscal deficit at times of unemployment, so that these psycho-

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"logical fears can be reduced as much as possible. The irrationality of some of these fears can be readily shown in many ways. The deficits of the provincial governments in fact in recent years have been very much more substantial than those of the Federal Government, and yet very few people are concerned to anything like the same degree about the financing of the provincial governments. Why is this so? I think one reason is that the physical assets of the provinces can be seen -- that is, the results can be seen. The other is purely an accounting device -- the fact that the provincial governments have two budgets, a current and a capital budget, which they separate. Their borrowings do not go into the current budget, and most of the provinces are able to show a surplus of a few million dollars a year in the current budget, when in fact they are borrowing one, two or three hundred millions a year.

The Federal Government does not have a capital budget in the same sense as the provinces do. Everything goes into the one budget; everything is current. All the capital assets, even where we are building airports and so forth, agriculture experimental stations and so forth -- these all go into the current budget, so that a deficit of the Federal Government is a very different thing

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"from one at the provincial level.

It is an extraordinary fact that twenty-five or thirty years ago, it was generally believed that low interest rates were here to stay forever. In the early thirties, the British converted their debt through a war loan conversion at low interest rates of about 2½% to 3%; our rates were fixed at around 3%, American rates at 2½%, and people then believed that not only were those rates justified at that time for that time, but forever. Now of course, people tend to believe the very opposite; that high interest rates are appropriate not only under the conditions of full employment and pressing inflation, but always. And this is the sort of psychological atmosphere in which we live and in which people tend to come to believe that what is true now must always be the case. Of course this isn't so.

Now I'd like to turn to the 'white side' -- the other side of the moon which isn't looked at so frequently -- the positive aspect of deficit finance. In the first place, it is perfectly clear that a large part of our deficit here, and that in the United States as well, is intended; it arises out of what are called the automatic stabilizers. These are those parts of the Federal revenue and

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"expenditure pattern which are built into the system. The income tax scale is a graduated tax of course, and when people are out of work or fall into a lower level of income, their tax automatically declines; this is intended. On the cash budget, as unemployment rises, so do unemployment payments; this also is intended. There are various other aspects of the Federal Budget which also automatically tend to increase expenditures as employment declines. So in many ways the deficit is perfectly intentional; it was built into the system from the beginning. Therefore, to fear it is to be inconsistent, since it was intended to produce those effects when necessary. We should not be apprehensive about it when it occurs. And yet, of course, there is much apprehension.

In the United States, Mr. Paul Samuelson, an economic advisor, has said recently that if the level of unemployment in the United States remains at less than 7½%, seasonally adjusted, he felt that a deficit in the order of five to seven billion or higher would be necessary under the present economic conditions. However, he said if economic conditions worsened to the point that the level of unemployment should exceed 7½%, then more drastic measures with regard to deficit

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"finance would have to be taken. And one could easily visualize under those circumstances the American deficit running to ten, twelve, fifteen billions. Similarly in Canada, under present conditions, we appear to be running a relatively modest deficit in relation to the level of unemployment."

47. We do not, however, wish to leave the impression that we believe that this marked contrast in the attitude of Europeans and North Americans to the role of fiscal and monetary policies in the national economy is the only factor explaining the difference in the economic growth rates on the two sides of the Atlantic. But we believe that it may be a very important factor.

48. We believe that there is a serious lack of understanding by the general public in Canada of the subject of public finance. This is often true even among otherwise well informed people. All too frequently a great deal of misunderstanding has been generated by editorial writers in the public press, who so often propound their archaic views on the subject with great zeal, self-righteousness and dogmatism. All too often such views reflect the dismal fact that their authors are years behind the latest developments in economic thought. This is all the more distressing, because so much has been contributed to our understanding of public finance in the past thirty years.

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severely concentrated in particular sectors of the economy, there may be significant price increases in those particular sectors, and some smaller price increases elsewhere. This could happen no matter how such government expenditures were financed, whether by deficit financing or by taxation. But it can happen just the same with private expenditures. The private investment boom in 1955-1957 caused the price of certain commodities to rise substantially.

50. To the extent that deficit financing merely raises the level of demand necessary to sustain full employment, it will be no more inflationary than if the same demand had been created by private spending. There is of course one school of thought which believes that it is not possible to have full employment without a certain amount of price increase. They argue that the high degree of demand necessary to sustain full employment will exert a relatively small but constant pressure on prices. Whether this argument is correct or not, it would apply equally whether adequate demand was brought about by government spending or by business spending.

51. It is often contended that expansionary public policies will create balance of payments problems. Again the argument usually is based on the assumption that such policies will lead to higher prices and the loss of export markets with a resulting deficit on current account. The answer again, however, is that so long as expansionary public policies do not raise aggregate demand in excess of productive capacity, the chance of inflation is minimal. Those who argue otherwise are actually implying that full employment is not possible

without creating a balance of payments problem.

52. Of course full employment policies would result in rising incomes. This in turn would probably lead to a rise in imports. But this would happen just the same if private investment or other non-government spending caused an upward turn in the economy. We must admit, however, that this matter may have been seriously complicated by the recent pegging of our exchange rate. We shall have more to say about this later on.

53. There seems to be a strongly held view in both Canada and the United States that foreigners will lose confidence in our respective currencies if we follow deficit policies. The quotations from European government and business people previously given would seem to cast doubt on this. Furthermore, it is hardly likely that European governments that have no hesitation in adopting deficit policies would be so arrogant as to pre-empt the privilege for themselves, or that European investors, who accept tranquilly their own governments' deficit budgeting would get panicky over ours!

54. As is well known, there has been in recent years a loss of confidence in the U.S. dollar which has caused at times a significant outflow of U.S. gold. Ironically, the deficit in the U.S. balance of payments, which has been responsible for the "flight from the U.S. dollar" is often attributed to U.S. budget deficits. If U.S. budget deficits had given rise to strong inflationary forces with the result that U.S. exports were "priced out of foreign markets", as is so often claimed, then this theory would make sense. But far

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from being the case, U.S. exports have stood up, and continue to stand up, exceedingly well in the world's markets. Last year U.S. exports of goods exceeded imports by over $5 billion. The fact that the U.S. still ends up with an overall deficit in her balance of payments is due, of course, to the fact that American corporations invest large sums abroad, and that the U.S. Government has large military and foreign aid commitments around the world.

55. In an interview, Dr. Paul A. Samuelson of M.I.T., widely considered to be one of the foremost American economists, was asked:

> " Would a larger budget deficit cause a loss of confidence in the soundness of the dollar, leading to trouble on that score?"

His answer was as follows:

> " The simple facts do not permit us to know how important this would be. I think that Europe will probably be just as worried if we languish into another recession or into very slow growth as they would be by a deficit, particularly if the deficit is under control and doesn't just come about because spending has gone haywire.
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56. This would seem to be confirmed by the current annual report of the Bank for International Settlements, a highly reputable and conservative institution, which advises the United States to:

> "...tackle its key economic problems by increasing the budget deficit to restore full employment while raising interest rates to curb the flow of funds overseas. (The reference to raising interest rates presumably means short-term rates, which U.S. authorities were reported to be preventing from falling in order to restrain the outflow of investment funds, while at the same time exerting a downward influence on long-term rates to encourage internal growth.) ... The report said that much of the time since 1956 the United States has found itself with unused labour and capital resources, partly because a decision could not be made on the appropriate fiscal action to induce resources to be taken up for their public services or private wants."

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57. If this report is correct, it would seem that the Bank for International Settlements, whose primary function is to promote "sound international monetary relationships", and whose Board of Directors is made up of Europe's most important central bankers, regards a full employment economy brought about by an unbalanced budget as likely to produce greater international confidence in U.S. currency than the alternative course of maintaining a balanced budget at the cost of serious unemployment. Since the U.S. dollar is one of the world's two reserve currencies, such a judgment could not have been arrived at lightly.

58. Another objection which is often raised to deficit financing is that it increases the national debt, and this is regarded by many as always bad. Unfortunately, there seems to be a great deal of misunderstanding by the general public on this matter. The tendency to regard an increase in the national debt in the same way as an increase in one's personal debt is only too prevalent. Some politicians and others who should know better have deliberately encouraged this thinking. Very seldom does any article or editorial in the press attempt to enlighten the public on this matter. The self-liquidating nature of budget deficits is not widely understood. There is little understanding of the fact that as public debt is increased for the purpose of expanding national income, increased tax revenues can be applied to the liquidation of the debt.

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Again, how often is the public debt judged by its absolute size rather than as a ratio to national income. The fact that our public debt is relatively smaller today than ten years ago is seldom appreciated: our debt is a little higher, but we are much richer, much better able to carry it. The public's serious lack of knowledge in such matters makes it exceedingly difficult for governments to use the national budget for promoting full employment policies. We hope that your report will have a salutary effect in this respect.

More Reliance on Selective Controls Needed

59. In any discussion of monetary policy, it is inevitably pointed out that the capital market is imperfect, and that hence a central bank policy either of restraint or of expansion will have an uneven effect on the various sectors of the capital market. This is no mere academic point. The past six years alone provide ample evidence of its importance. It is therefore all the more surprising that so little progrss has been made in Canada to change this situation. Except in periods of emergency, there is almost sole reliance on general monetary controls to regulate credit. However, this has had certain undesirable effects in recent years.

60. Those who favour using only general controls argue that these are impersonal and non-discriminatory. That they are impersonal cannot be denied. That they are non-discriminatory is, however, highly questionable. The uneven effects which general monetary restraints have on the various sectors of the economy contradict

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this view.

61. A tight money policy, the result of the central bank's open market operations in reducing the banks' cash reserves, is undoubtedly necessary when there is excessive general demand throughout the economy. A good example of this was the early post-war period, when it was perfectly apparent that demand was excessive and widespread. Given this kind of situation, there may be need to restrain spending in all sectors of the economy. This is the kind of inflation which the central bank is at its best in checking. Other considerations, however, and in particular the fear of a recession setting in shortly after the end of the war, led the Bank of Canada to pursue an easy money policy. This policy thus actually encouraged, rather than restrained, demand inflationary forces. It would be unfair to single out the Bank of Canada for blame, because most informed observers at the time were convinced that anti-recession, instead of anti-inflation, measures were required. But then they could not be expected to foresee the outbreak of the Korean War and the build-up of large defence programmes.

62. But what is really puzzling is the fact that the Bank of Canada has adopted restrictive policies when it was apparent that such policies were being applied at the wrong time. For example, it applied a tight money policy to curb certain inflationary pressures in the period 1955-1957. But the inflationary pressures at that time did not result from excessive general demand. The inflation of those years was most certainly not a con-

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sumers' inflation, that is to say, with effective consumer demand in excess of productive capacity. It was, instead, an investment inflation, brought on by excessive private capital spending. The central bank, however, is scarcely able to deal directly with corporate investments. This is because corporations draw largely on sources of capital which are virtually outside the central bank's control. These sources are internally generated savings (depreciation allowances and undistributed profits) and, to a lesser extent, the capital market.

63. According to a study made by the Bank of Nova Scotia (Monthly Review, September, 1956 -- "Financing a Decade of Corporate Investment"), in the ten year period, 1946-1955, total corporate investment in fixed capital goods and in inventories was $24 billion. Three-fourths of this sum, or $18 billion, resulted from internally generated savings. Depreciation allowances alone accounted for about 46 per cent of total capital funds. Only fiscal measures can deal with the principal source of private capital funds, internally generated savings.

64. While it is true that the central bank affects the capital market by its ability to influence interest rates, it is doubtful that an increase in interest rates has much effect in deterring corporations from raising capital during a boom. Interest rates are, for them, usually a negligible part of production costs. An increase in interest rates on corporate borrowing may be more than offset by the relatively easy profits to be made as prices go up during a boom. Furthermore,

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66. While it is questionable, therefore, whether a tight money policy has any appreciable effect in restraining inflationary pressures caused by excessive corporate spending, it can have a significant effect on other economic groups who may not have any responsibility for generating inflationary pressures. An increase in long-term interest rates has a major effect on provincial and municipal governments, and other public bodies which raise loans in the capital market. Unlike corporations, they are not engaged in profit-making enterprises and thus cannot offset higher interest rates with higher profits. Furthermore, they are not endowed with the privileges of corporations that can offer a variety of capital instruments, such as common or preferred stocks, convertible debentures, commercial paper, and so on, which gives them a considerable advantage in competing for capital funds.

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68. Another economic group who suffered during that tight money period were smaller businesses, who must invariably finance most of their needs through bank credit. Financial requirements of smaller businesses generally are not large enough to justify their raising loans in the capital market. When the central bank restricts bank credit, smaller businesses are among the first to be hurt.

69. Rising interest rates seriously discriminate against prospective home-builders. Even a comparatively small increase in the mortgage rate can be a significant addition to the total cost of building a home. The deterrent effect which this has on house-building will of course have repercussions elsewhere in the economy.

70. It would seem, then, that monetary policy intended to curb inflation caused by excessive private capital expenditures, especially by large corporations, makes no sense if its main effect is to curb economic activities not responsible for causing inflation, while leaving the rate of private capital expenditures comparatively untouched. Such policy slows down growth in economic sectors which need it, and leaves relatively unaffected those which should be retarded. The net result can only be unemployment and unbalanced economic development.

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72. What selective controls could be applied to restrain or prevent an investment inflation of the kind that took place in the period, 1955-1957? Since depreciation allowances are the principal single source of investment capital, they must be subject to public regulation if capital spending is to be effectively controlled.

73. One method which may have distinct possibilities is a variable depreciation rate. The rate of depreciation that is deductible from corporate taxable income would be subject to change in accordance with economic conditions. For example, when an unhealthy boom threatened, the rate of depreciation allowances for tax purposes could be reduced accordingly. On the other hand, when economic activity showed signs of slowing down, the depreciation rate could be increased to provide the necessary incentive to invest. Increases and decreases in the depreciation rate would over the long run tend to balance each other, so that corporations should neither lose nor profit from the use of a variable depreciation rate.

74. Another selective control which could help prevent investment inflation is the licensing of the sale of large capital issues. In other words, approval would have to be granted before capital issues

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exceeding a set value could be sold in the market. Public regulation of capital issues, carried out through the Capital Issues Committee, has long been in effect in the United Kingdom.

75. Control over capital issues in this country might, of course, raise constitutional problems, since the Courts might hold that this matter falls under section 92, head 13 of the British North America Act, 1867, "property and civil rights in the province". Conceivably, the judges might be persuaded that such control is, under modern conditions, ancillary to control over "banks and banking", and therefore a legitimate exercise of the exclusive authority of Parliament over that subject. On the other hand, they might not be so persuaded. This would necessitate a constitutional amendment. We hope that, if you become convinced that control over capital issues is necessary, the admitted difficulties of amending the Constitution will not deter you from recommending such control.

76. The ability to regulate capital issues and to exercise some control over depreciation allowances would enable our public authorities to gain considerable regulatory power over the main sources of corporate investment funds.

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quality of our goods and services. To the extent that they do not, they have an upward price bias. While the degree of bias is of course not known, nevertheless, it is almost certain that it would constitute a fairly significant proportion of any moderate increase in the indexes.

78. Price increases may be caused by other factors which have nothing to do with excess demand. They may be caused by manufacturers in a position to "administer" prices, in which cases prices would be set without reference to market supply and demand forces. They may be raised through the collusion of companies, as investigations carried out under the Combines Investigation Act have proved. Recently certain concerns raised prices to take advantage of the devaluation of the dollar. We know that such factors as these can, and do, keep prices up, or rising, when effective demand is not exerting excessive pressure on supply.

79. This leads us to this conclusion: unless it is clearly discerned that price increases result from excessive demand on the nation's productive capacity, general credit restraint should not be imposed. To do so would only curb aggregate demand and bring on unemployment without checking price increases caused by factors other than excess demand.

Influence of Central Bank on Interest Rates

80. We find it difficult to understand the Bank of Canada's policy on interest rates since 1956, at any rate until very recently. This policy has been passive, as clearly indicated in the Bank's 1956 Annual

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"The central bank, like other institutions operating in the capital market, buys and sells Government securities and bids for treasury bills at the weekly tender. These and other day-to-day operations of the Bank, including its lending to banks and money market dealers, have an influence on the level of interest rates, generally in the direction of resisting rather than inducing or adding to movements of interest rates. (underscoring ours). In other words the Bank will normally be buying government securities on a declining market and selling on a rising market.

In its day-to-day operations the Bank generally offers some resistance to changes in interest rates (in either direction) in the interests of maintaining orderly conditions in financial markets. However the Bank has always made it quite clear that the establishment or maintenance of any particular level of interest rates is not an objective of central bank policy" (pp. 48-49).

81. This last statement is incorrect, because the Bank of Canada followed a deliberate policy in the early post-war period of supporting Government of Canada bond prices for the purpose of fostering low interest rates.

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does not accept the responsibility of giving some positive guidance and influence as to what the level of interest rates should be, is failing to fulfil one of its primary functions, the regulation of the cost of money in accordance with economic requirements. It is true that the effect of the central bank's operations in making changes in the money supply will be to exert some influence on interest rates. But a conscious policy to influence interest rates in accordance with economic requirements is surely needed in any modern economy.

83. It seems to us that there are good grounds for going even further, by suggesting that the Bank of Canada should consider adopting a regular policy of maintaining low long-term interest rates. The expansion of urban communities will require greater and greater sales of debentures and bonds by municipal and provincial governments. Public facilities and services of a wide range are expected to claim an increasingly larger proportion of national production. Better housing is required by a large part of the public. It is therefore in the general interest that these things be financed as cheaply as possible through low interest rates. High interest rates will only retard, or at least make very expensive, the meeting of these important public needs.

84. The Bank of Canada can maintain low interest rates by its support of Government bond prices, as it succeeded in doing in the earlier post-war period already referred to. Some will object that this would be inflationary, because of the effect on the banks'

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cash reserves. But it would not, provided that the Bank of Canada used the power which was granted to it in 1954 of changing the cash reserve requirements of the chartered banks if necessary. It could neutralize the effect on reserves by raising the cash reserve requirements of the banks.

85. The power to vary the banks' reserve requirements, which the Bank of Canada has never used, is important, then, in enabling the central bank to undertake appropriate action with respect to the bond market without necessarily increasing the money supply. There need be no conflict, therefore, between maintaining stable bond prices at low yields and, if necessary, at the same time preventing an unwise increase in cash reserves. Moreover, with an expanding economy, the need for a gradually expanding money supply would probably require the infrequent use of this device.

The present statutory provision allows the Bank of Canada to vary the banks' cash reserve requirements between 8 and 12 per cent of deposit liabilities, and within this range, the Bank is permitted to change the reserve requirement by 1 per cent at a time, after giving a month's notice. In order to provide the Bank of Canada with greater leverage, there would seem to be a good case for abolishing the legal limit of 12 per cent. The gradual change in reserve requirements, carried out at infrequent intervals and only after adequate notice had been given, would prevent any disruption of chartered bank activities.

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Control of Financial Intermediaries

87. We suspect that a major weakness in our financial system is the fact that financial intermediaries, or "near banks", are not subject to any kind of monetary control. They include such institutions as instalment finance companies, personal loan companies, trust and loan companies, and others. They appear to be exerting an increasingly strong influence on the economy, and they constitute a formidable rival of the banks in monetary importance. Many students of monetary economics have

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become increasingly aware of the fact that unless a measure of control over these institutions is co-ordinated with control over the banking system, monetary policy will become increasingly less effective.

88. Those who oppose bringing these institutions under monetary control argue that, unlike the banking system, they do not create credit. Hence, it is alleged, they do not influence the volume of the money supply, but serve as a medium between those who have savings to lend or deposit and those who desire to borrow. This is of course true. But this argument overlooks a very important fact. While financial intermediaries do not affect the volume of money, they probably have a significant influence on the velocity of money, and hence on prices and output. It seems to us, therefore, to make little sense that when the central banks is restraining bank credit, these institutions are not restrained from carrying on normal activities. Furthermore, there is nothing to prevent those holding money in current accounts in banks from switching into so called "near-money substitutes" of certain intermediaries to take advantage of rising interest rates during a tight money period. The highly liquid assets of some of these institutions make attractive investments, because they can be quickly converted back to cash.

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bank will become increasingly less effective. If this should prove to be the case, we would be particularly concerned lest the central bank, in order to make its tight money policy more effective against possible future inflationary pressures, should apply increasingly greater restraint on bank credit. We cannot help but feel that this has already happened on previous occasions when the Bank felt it necessary to apply a tight money policy. Had it had some way of restraining the activities of the non-banking financial institutions in the past, might it not have adopted a less stringent policy towards monetary expansion?

90. We are very much concerned about this whole matter because we believe that it can have an important bearing on employment. We believe that central banking operations have at times in the past been used to curb inflationary pressures over which the Bank did not have direct influence. This only contributes to unnecessary retardation of growth and to unemployment in sectors of the economy not responsible for generating inflation. That is why we have argued that more emphasis should be placed on selective rather than general controls. Bringing the non-banking financial intermediaries under central bank control would be a further step in this direction.

91. The former Governor of the Bank of Canada, Mr. James Coyne, in his Annual Report for 1956, pointed out the difficulty of carrying out an effective monetary policy with instalment finance companies operating entirely outside public regulation:

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> " The existence of what amounts to a rival banking system, competing for deposits and short-term funds in order to make short-term loans to finance consumption (and to an increasing extent the instalment finance companies also make loans to industrial contracting, transportation, merchandising and other businesses) without supervision or regulation, and out of step with the trend of credit policy in the regular banking system, can be a definite handiczp to monetary policy during a boom, and will also have de-stabilizing effects during any recession of activity that may ensue" (p.27).

92. It would seem to us that the Bank of Canada should be empowered to regulate the activities of financial intermediaries. How this should be done is something that would require careful study. Perhaps one method for facilitating such control would be to require them to adopt reserve ratios which the Bank of Canada could <u>vary</u> as monetary conditions required. For example, if conditions required a certain restraint on the activities of these intermediaries, the Bank of Canada could raise the reserve requirement; if, on the other hand, easier credit conditions were required, the reserve requirement could be lowered. The raising of the reserve requirements would reduce velocity, while the lowering of reserve requirements would raise velocity. Although this is a matter of great complexity, its importance is such, we feel, as to warrant most careful

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94. Recent changes in exchange rate policy have particular significance for monetary policy. Indeed, the new policy of fixing the exchange rate will almost certainly have an important bearing on the kind of monetary policy the Bank of Canada can adopt. We are especially apprehensive that a fixed rate will make it difficult for Canada to pursue expansionary monetary and fiscal policies which are necessary to achieve full employment and suitable economic growth rates.

95. A free exchange rate, that is to say, a rate of exchange determined by the supply and demand for foreign exchange, is preferable for Canada with its comparatively large external transactions. Under such circumstances, a free rate is helpful in adjusting our balance of international payments to meet our domestic needs. However, with a fixed exchange rate, domestic

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policies may well have to be adjusted to meet balance of payments requirements. This means that policies which may actually promote unemployment and low growth rates may be adopted because they are considered essential to the requirements of our balance of payments.

96. Indeed, the present balance of payments problem underlines the need for a free exchange rate for Canada. We believe that with a free rate, together with positive policies to stimulate exports of goods and services, our present external difficulties could be greatly reduced and there would be no need to employ either external or internal policies of a restrictive type.

97. The Congress reluctantly recognizes the need for the present emergency import restrictions, but they are essentially negative and should be regarded as temporary. We believe that it would be most unwise to think of these restrictions as a long-term solution. It is here where we part company with those who believe that Canada's external deficits can best be cured by a regular policy of restricting imports into this country.

98. We believe that any attempt to make the present emergency surcharges on imports permanent, or to implement any other long-term import restrictions, would only result in harmful price increases in our economy. Further devaluation of our dollar would do the same. Increased costs might have a serious effect on our ability to export, and we should thus be no nearer, perhaps even farther off from, solving our balance of payments problem.

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99. Furthermore, such restrictive measures are out of step with today's need for substantial liberalization of world trade. They are out of step with the virtually revolutionary tariff changes which the Kennedy administration is attempting to bring about between North America and Western Europe. The inescapable fact is that the traditional method of using severe restrictive external measures to cure a balance of payments problem is no longer tenable in a world which is seeking to expand trade. Any important trading nation which adopts such a cure will affect somebody else's balance of payments. For example, while the U.S. appreciates why Canada has recently imposed surcharges on a wide range of imports, she is nevertheless concerned that such restrictions must inevitably aggravate her own balance of payments problem. It is therefore imperative that nations seek more positive means in dealing with external deficits.

100. Many Canadians have been led to believe that deficits in our transactions with the outside world are chiefly, if not wholly, the result of a serious imbalance in merchandise trade. Perhaps this is because figures on our current account transactions with the rest of the world are sometimes reported loosely in the press. Such misunderstanding on the part of the public is undoubtedly the reason why so many over-dimplify the problem, and why it leads them to urge, among other things, restrictions on merchandise imports to bring them into line with exports.

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indefinitely to incur large annual deficits on current account, certainly not without offsetting net capital inflows. Nor can we borrow indefinitely from the IMF and other international financial institutions to replenish our exchange reserves. Without some positive programme over the long-run, this country could be faced with frequent serious financial crises.

102. It would appear that somehow we are going to have to increase our exports of goods in order to compensate for certain recurring deficits on "invisibles", such as the deficit on dividend and interest payments. (Last year the deficit on the latter was 57.1 per cent of the total deficit. Preliminary figures, D.B.S.)

103. For years the United States has exported substantially more goods than she has imported, which has helped to offset deficits in non-merchandise transactions. (Even with large favourable balances of trade, deficits on "invisibles" continue to leave her with significant overall deficits). It would appear that Canada is going to have to do the same if she is to offset her large deficits on "invisibles". We suggest, therefore, that careful consideration be given to adopting the most effective possible measures to boost merchandise exports. For example, export subsidies might be one such measure. A further improvement in export credit facilities might be another. Tax incentives to firms which exceed certain export quotas might still be another.

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will not meet with the approval of nations competing with us in international trade. Be that as it may, other countries, especially those favoured with surpluses in their external accounts can have little justification for opposing essentially positive measures by deficit countries. Such measures are surely preferable to the adoption of higher tariffs or other import restrictions, with their contracting effect on trade.

105. There may also have to be important changes in the structure of some of our secondary industries. In some cases there are too many firms operating in a comparatively small Canadian market, which only results in unnecessary inefficiencies. The time may be at hand when a certain streamlining of our industries may be essential, if not indispensable, to enable us to better compete with larger foreign industrial units.

106. We believe that there is a good deal of room for improvement in the Canadian tourist industry. While Canada is not endowed with a Palm Beach or a Riviera, she is far from being devoid of attractive natural tourist spots. What is needed is a major programme by the Federal and Provincial Governments to give all possible assistance in developing our natural sites and in disseminating information to attract foreign tourists to Canada, as well as encouraging Canadian tourists to do more of their travelling inside Canada.

107. However, while we believe that measures such as these are needed to increase our exports of goods and services, we are still doubtful that Canada can avoid serious balance of payments problems in the future with a

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fixed exchange rate. We realize of course that members of the International Monetary Fund are obligated under the Fund's agreement to fix their exchange rates. It is our view, therefore, that Canada should seek either outright repeal of this provision to enable countries like ours to adopt a free exchange rate with its "self-correcting" mechanism, or, at the very least, an amendment allowing exchange rates to fluctuate within appreciably wider limits. Otherwise, we are apprehensive that fiscal and monetary policies in Canada may have to be used in the first instance to support the country's exchange rate rather than serve primarily the goals of greater employment and output. Should this prove to be the case, the Canadian economy may well enter a long period of stagnation, with unprecedented post-war rates of unemployment.

108. The best exchange rate policy for Canada, we submit, is to get back to the floating rate. The next best is to get the International Monetary Fund rules changed to allow the fixed rate more flexibility. If this country can neither get back to a floating rate, nor get a more flexible fixed rate, then, we submit, it will have to press, and press hard, for new international monetary arrangements which will provide for a far greater degree of international liquidity than now exists. For countries which have a fixed exchange rate, this is a problem which is becoming increasingly important, and which will have to be attended to before long. We are referring to the increasing difficulties besetting the international monetary system. The supply

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> "...gold has long ceased to provide an adequate supply of international liquidity for an expanding world economy. More than half of the world's liquidity requirements have been derived in recent years from the enormous growth of foreign exchange reserves, and particularly of dollar balances, alongside of gold itself. The implications of this trend for the future stability of the world monetary system are, however, extremely disquieting." (Gold and the Dollar Crisis, Robert Triffin, Yale University Press: 1961, p. 54).

109. The system whereby nations have been holding a considerable proportion of their international reserves in the form of foreign exchange, and especially in dollar claims, is beginning to break down.

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111. However, it has become apparent that the Americans cannot continue indefinitely piling up external deficits and settling them in dollars. As continued deficits in the U.S. balance of payments have resulted in increases in foreign holdings of dollars, and hence in potential claims on the American gold reserves, there has been a sharp decline of confidence in the American dollar. In recent years this has caused an outflow of gold of such proportions as to cause American authorities to become seriously concerned.

112. The Congress recognizes that Canada alone cannot change the present, inadequate international liquidity arrangements. But we suggest that, if you feel unable to recommend either outright return to a floating exchange rate, or a more flexible fixed rate, then it becomes imperative for you to consider carefully what policy Canada should adopt towards the various plans for greater international liquidity, and to make recommendations accordingly. Such recommendations could then serve as a basis for Canadian proposals in the international negotiations on this subject which cannot be much longer postponed.

113. We come finally to the question of changes in the Bank of Canada Act and in the way the Bank functions.

On the whole, we think the Act itself is

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adequate. We have, however, six specific changes to suggest:

(a) The preamble to the Act should be amended by inserting, after the words "production, trade, prices and employment", in the sixth line, the words, "and to promote full employment". This would make clear, beyond shadow of doubt, that full employment (not simply mitigating fluctuations in the general level of employment) is one of the major objectives of national policy in general and of national monetary policy in particular.

(b) Section 6 (3) (a) should be amended to make clear the precise procedure to be followed in removing the Governor or Deputy Governor, so as to preclude the repetition of what went on a year ago when the Government, in order to remove the then Governor, felt that it had to resort to an amending Bill declaring the office vacant. If it is considered necessary to place the Governor and Deputy Governor beyond the reach of dismissal by the Government of the day, proprio motu, then we suggest that the paragraph should be amended by adding the words, "but may be removed from office at any time by the Governor General, on Address of the Senate and House of Commons". This would place the Governor and Deputy Governor in the same position as Judges of the Superior Courts, the Auditor-General, the Chief Electoral Officer, the Civil Service Commissioners, the Transport Commissioners, the

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members of the Board of Broadcast Governors, the members of the National Energy Board, and the Directors of the Canadian Broadcasting Corporation (except the President and Vice-President). On the other hand, if it is felt that the Governor and Deputy Governor should not be placed in so independent a position, then the paragraph might be amended by adding the words, "but may be removed for cause at any time by the Governor in Council". This would place the Governor and Deputy Governor in the same position as the members of the Tariff Board, the Wheat Board and the Canadian Pension Commission, and the President and Vice-President of the Canadian Broadcasting Corporation. Or the Act might borrow from section 62 (2) of the Bank Act, which provides that the Inspector-General of Banks shall hold office during good behaviour, but may be removed by the Governor in Council "for misbehaviour or incapacity, inability or failure to perform his duties properly".

(c) Steps should be taken to make the Board of Directors really effective, which it does not appear to be now. It should function in roughly the same way as the Court of Directors of the Bank of England. This change may not require any amendment to the Act, though we think it should be specified, in section 10 (1) that a due proportion of the Directors should be people of financial experience or special knowledge in the field of monetary economics, but it might well require a change of Government policy

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in the selection of directors.

(d) The Act should distinctly provide, as the British Act does, that the final responsibility for monetary policy rests with the Minister of Finance. This would preclude repetition of the performance, in which both Liberal and Conservative Ministers have indulged, of disclaiming responsibility for monetary policy. It is, as the present Government ultimately decided, intolerable that the Bank of Canada should constitute an <u>imperium in imperio</u>, an independent, sovereign power, pursuing a policy the direct opposite of the Government's own fiscal policy; and the language of the Act should be such as to make it impossible for any future Minister to talk nonsense on this point. It is hardly necessary to add that the Congress does not want to see the Bank become a department of the government, or the plaything of partisans. We are just as anxious as anyone else to keep the management of the Bank in competent hands, and to free it from day-to-day political independence in high policy which some Ministers in the past have claimed for it.

(e) The Auditor-General should be designated as the Bank's auditor. At present, the operating expenditures and revenues of the Bank are not open to public scrutiny. The Congress adopts as its own Professor Scott Gordon's concluding remarks in his article on "The Bank of Canada in a System of Responsible Government" (<u>Canadian Journal of Economics and</u>

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Political Science, Vol. XXVII, no. 1, Feb. 1961, pp. 1-22):

" It may be argued that if the government controlled the Bank of Canada it could make special financial deals for political purposes. If we assume, however, that the Bank of Canada as it is now constituted never makes special deals of a questionable nature we may be assuming too much. If the Bank of Canada were to engage in such a transaction, it would probably never see the light of day. But if the Bank were a department, or the Auditor General were designated as the Bank's auditor, which he is not, any irregularities of this nature would find their way into the Auditor General's report and would thus be opened to the scrutiny of Parliament and the general public. The independence of the Bank of Canada from the Auditor General does not guarantee the integrity or impartiality of the Bank's practices nearly as much as it guarantees their secrecy. It has often been suggested that central banking activities must be shrouded in secrecy (and kept hidden for many years after the event) if central banks are to do their work effectively, but this is merely a myth that has been perpetuated by the sub-culture of the financial world, and by the Bank of England in particular. Finan-

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(f) The Bank of Canada Act should itself provide for periodic, and fairly frequent, revision. The Bank Act, in effect, provides for its own revision every ten years. We are inclined to think that, in a world of increasingly rapid economic change, both Acts should be subject to revision at more frequent intervals. This would, incidentally, provide more ample, and frequent, opportunities for public education in the subjects concerned, through the hearings which would take place either before a Royal Commission or a Parliamentary Committee.

114. More important than any changes in the Bank of Canada Act itself, however, is the spirit in which, and the purposes for which, it is used. The late Professor Stefan Stykolt, of the University of Toronto, in a speech to the same Ontario Federation of Labour Study Conference on Unemployment from whose Report we have already quoted, laid down certain principles which appear to the Congress to be both indispensable and

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and incontrovertible:

> " One of the main tools which can be used in the task of creating new jobs is a positive monetary policy. Monetary policy is the government's policy which determines the size, availability and cost of credit in the economy. Positive monetary policy has a number of characteristics which make it a useful weapon in the struggle with economic instability .....
>
> Monetary policy must be part of the democratic process. This means that the government, and in particular the Minister of Finance, must accept responsibility before Parliament for the conduct of monetary policy, for its goals and its methods. He must be prepared to explain it candidly, defend it against criticism, declare his confidence in the institutions and in the individuals who manage it and participate in its formulation as the arbiter of the last resort. Only if monetary policy, like defence policy or foreign policy, is made part of the process of responsible government can it be positive in responding to the real needs of the country, as expressed by public opinion inside Parliament and out. Only then can monetary policy be coordinated with other types of economic policy which the government

"is or ought to be pursuing .....

Positive monetary policy must be consistent. The goal which monetary policy pursues at any moment must be clear first of all to the officials who implement policy, secondly to those who bear the brunt of policy in the first instance, that is to the entire financial community, and thirdly, to the public at large to whom the purpose of policy must be explained clearly rather than be obscured by contradictory and mystifying statements .....

.....The authorities' intentions must be clear, unequivocal and unambiguous to all concerned. At any one time all the signals by which the course of monetary policy is made manifest to the financial markets and to the public at large must point in the same direction. For only then can the individuals and institutions whose co-operation is essential if monetary policy is to be effective in attaining its goal ... play their proper part. Specifically, the movements in the stock of money, the changes in the discount rate, and the speeches of the Minister of Finance and of the officials of the Bank of Canada must all tell the same story. If they do not the result is sullen confusion in financial markets which makes monetary policy ineffective, if policy can be

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"said to exist when conflicts in its goals remain unresolved. Consistency requires also that the goal of monetary policy be altered only in response to an evident change in the country's economic conditions. If the country moves from a period of very high employment and inflation to a period of very high unemployment and price stability the goal of policy must change from restricting the level of economic activity to increasing it by every means well-known to professional students of the subject. But the goal of policy cannot shift about from week to week or month to month without any objective change in the country's economic conditions. Inexplicable and violent fluctuations in the goal of policy are demoralizing and blunt the instrument at a time when it may be needed most ......

Finally, monetary policy must be consistent with that other branch of economic policy designed primarily to attain a high and stable level of employment and of prices, namely fiscal policy. In periods of depression, budgetary deficits must be financed with the help of monetary expansion. In periods of inflation, budgetary surpluses may be used to bring about monetary restraint."

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Respectfully submitted on behalf of the CANADIAN LABOUR CONGRESS,

Claude Jodoin, President

Donald MacDonald, Secretary-Treasurer

William Dodge, Executive Vice-President

J. Morris, Executive Vice-President